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Real Estate Principles

Pilot Edition

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Introduction

Real Estate Principles is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Real Estate Principles, Real Estate Practice, Real Estate Finance, Real Estate Legal Aspects and Real Estate Property Management.

The material in **Real Estate Principles** is a collection of the fundamental brokerage topics a new agent or broker will be exposed to during their first four years of practice. Each chapter covers a topic of concern to both brokers and agents, including: basic agency issues, fair housing law, property related disclosures, real estate ownership concepts, adjacent owner issues, title and vesting, notes and their provisions, trust deeds, financing, default and foreclosure, property management, construction and real estate math concepts.

All of this material is based on current **California law** and controlling **federal law**.

Included at the beginning of each chapter is a summary of the topics covered within the chapter as well as a list of key terms essential to the reader's comprehension of the issues discussed. The first instance of a key term in each chapter will appear in *italics*, with the subsequent reference to the term appearing in **bold**. Although bolded words denote a subsequent reference to a key term, bold typeface is also used for emphasis where the editors have deemed appropriate.

Unless a form cited in the book says, "See Form XXX *accompanying this chapter*" [emphasis added], it is not in the book. Unless the form accompanies the chapter, it is not crucial to your understanding of the material.

However, you can access a fillable and savable version of all referenced **first tuesday** forms on the ***first tuesday*** *Forms-on-CD* which came with your enrollment package. The CD contains all 350+ **first tuesday** real estate forms, plus a **digital version of our entire library** of sixteen books.

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Agency

Chapter 1 — Agency: authority to represent others

This chapter explains the agency relationship between a real estate broker, his agents and his client.

For a further discussion of this topic, see Chapter 1 of the "Agency" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 1 Outline

Licensing scheme creates competency
Real estate jargon
What is an agent?
Creation of the agency relationship

Chapter 1 Terms

Agency	*Principal*
Broker	*Professional competency*
General duties	*Standards of diligence*
Primary duties	*Subagency*

Licensing scheme creates competency

Webster defines an agent as "a person...empowered to act for another." [Webster's New World Dictionary, Third College Edition (1988)]

Black's Law Dictionary describes agency as "A fiduciary relationship created by express or implied contract or by law, in which one party (the *agent*) may act on behalf of another party (the *principal*) and bind that other party by words or actions." [Black's Law Dictionary, Eighth Edition (2004)]

The agency relationship can be as principal and agent, master and servant, or employer/proprietor and employee/independent contractor.

When the agency involves real estate as its subject matter, the California legislature has devised a **licensing scheme** to establish a minimum level of *professional competency* for licensing of individuals who can then act as agents in real estate related transactions.

A governmental agency, the Department of Real Estate (DRE), was created to oversee licensing and police a minimum level of competency for individuals desiring to represent others as real estate agents. Presently, this goal is pursued through the education of individuals who seek a license or are up for relicensing.

The education is offered in the private and public sectors under government certification.

Agency in real estate related transactions includes relationships between:

- *brokers* and members of the public (clients or third parties);
- licensed *sales agents* and their brokers; and
- *finders* and their brokers or principals.

The **extent of representation** owed to a client by the broker and his agents depends on the *scope of authority* the client gives the broker, whether it is given orally, in writing or through the client's conduct with the broker. Also, minimum acceptable *standards of diligence* are set by the California legislature, the DRE and the courts.

Agency and representation are synonymous in real estate transactions. A broker, by accepting exclusive employment from a client, undertakes the task of aggressively using *due diligence* to represent the client and attain the objectives sought by the client. An open listing only imposes a *best efforts* standard of representation.

Real estate jargon

Real estate jargon used by brokers and sales agents tends to create confusion among members of the public. When the jargon is used in legislative schemes, it adds a high degree of statutory chaos, academic discussion and judicial and public consternation over the duties of the real estate licensee.

For example, the words **real estate agent**, as used in the brokerage industry, mean a *real estate salesperson employed by and representing a real estate broker*. Interestingly, real estate salespeople rarely refer to themselves as sales agents. Instead, they call themselves "realtors" or "broker associates."

Legally, however, a client's real estate agent is defined as a *real estate broker who undertakes representation of a client in a real estate transaction*. A salesperson is legally *an agent of the agent*.

The word "subagency" suffers from even greater contrasts. Subagency serves both as:

- jargon for fee-splitting agreements between Multiple Listing Service (MLS) member brokers in some areas of the state; and
- a legal principle for the authorization given to one broker by another (listing) broker to also act as an agent on behalf of the listing broker's seller.

- What is clear about real estate agency is the *primary duties* a broker and his agents owe the client, rather than the *general duties* owed to all parties regarding the real estate involved in the transaction. **Primary duties** owed a client, based on the best of the broker's knowledge, include:

- *evaluating* the financial impact of the proposed transaction on the client;

- *advising* on the legal consequences of documents which touch and affect the client in the proposed transaction;

- *considering* the tax aspects of the transfer, except in one-to-four unit residential sales; and

- *reviewing* the suitability of the client's exposure to a risk of loss on the transaction.

Clients can rescind all real estate contracts in a transaction when *dual agency* circumstances go undisclosed at the time they arise. The broker has misrepresented his agency to others in the transaction.

To care for and protect both their clients and themselves, all real estate licensees must:

- *know* the scope of authority given to them by the employment agreement;

- *document* the agency tasks undertaken; and

- *possess* sufficient knowledge, ability and determination to perform the agency tasks undertaken.

In all tasks undertaken on behalf of a client, a licensee must conduct himself at or above the minimum acceptable levels of competency to avoid liability to the client or disciplinary action by the DRE.

What is an agent?

An agent is an individual or corporation who **represents another**, called the *principal*, in dealings with third persons. Thus, a principal can never be his own agent since a principal acts for his own account, not on behalf of another.

The representation of others undertaken by a real estate broker is called an *agency*. Three parties are referred to in agency law: a principal, an agent and third persons. [Calif. Civil Code §2295]

In the brokerage of real estate transactions:

- the *agent* is the real estate broker retained to represent a client for the purposes hired;

- the *principal* is the client, such as a seller, buyer, landlord, tenant, lender or borrower who has retained a broker to sell or lease property, locate a buyer or tenant, or arrange a real estate loan with other persons; and

- *third persons* are individuals, or associations (corporations, limited partnerships and limited liability companies), collectively called *persons*, other than the broker's client, with whom the broker has contact as an agent acting on behalf of his client.

Creation of the agency relationship

An agency relationship is created in a real estate transaction when a person, called the *client* or *principal*, employs and authorizes a broker, called the *agent*, to act on his behalf in the future. [CC §2307]

A broker's representation of a client, such as a buyer or seller, tenant or landlord, borrower or lender is properly undertaken and the fee agreement enforceable only after a written employment agreement has been signed by both the client and the broker. This employment contract is loosely referred to in the real estate industry as a "listing agreement." [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

The broker's agency can also be created by an **oral agreement** or **conduct** of the client with the broker or other individuals. However, the fee arrangements would be unenforceable since no written agreement exists.

Also, some pre-printed, pre-1989 purchase agreements still in use contain a brokerage fee provision located below the signature of the buyer. The provision improperly stated the seller employs both the seller's broker and the buyer's broker.

However, the intent of the brokers using the form is merely to split the fee to be paid by the seller.

This acceptance/fee provision becomes the seller's *employment* or *ratification* of the buyer's broker as an agent of the seller — even though the buyer's broker may never have acted on behalf of the seller, acting at all times exclusively as the agent for the buyer.

This ill-conceived and combined acceptance/fee provision establishes the buyer's broker as the seller's subagent, or joint agent with the listing broker, a generally unacceptable legal consequence for the seller since unknown representations made to the buyer by the buyer's broker are then binding on the seller. [**Johnston** v. **Seargeants** (1957) 152 CA2d 180]

These acceptance/fee provisions were finally altered to avoid imposing liability on the seller for representations made by the buyer's broker. The revision was necessary to avoid conflicts with the agency confirmation law enacted in the late 1980s for one- to-four unit residential sales.

Chapter 2 — The agency law disclosure

This chapter sets forth the use of the statutorily mandated Agency Law Disclosure form and its timely presentation to sellers and buyers in order to perfect a broker's right to collect his fee.

For a further discussion of this topic, see Chapter 2 of the "Agency" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 2 Outline

Legislated order
Uniform jargon and agency law
Agencies confirmed in the purchase agreement
Use of the Agency Law Disclosure
Agency rules for a seller's listing
Documenting a refusal to sign

Chapter 2 Terms

Agency Law Disclosure	*Exclusive agent*
Agency confirmation provision	*Memorandum*
Broker obligations	*Perfection of rights*
Buyer's agent	*Rules of agency*
Documenting the refusal	*Seller's agent*

Legislated order

As the practice of real estate brokerage developed and matured, rules and regulations were created to keep transactions running smoothly and to channel agency activities toward a broader public good.

However, when the professional misconduct of real estate licensees was overlooked and mishandled by the brokerage community, legislative and judicial forces felt compelled to step into the "power vacuum" created by the lack of proper internal policing. Thus, an agency disclosure law to cure some of these deficiencies was enacted by the California legislature.

The real estate agency law requires two different sets of **agency-related disclosures**:

- an *Agency Law Disclosure* form setting out the "rules of agency" controlling the conduct of real estate licensees in a transaction; and

- an *agency confirmation provision* in purchase agreements to disclose the agency of each broker involved in the transaction.

AGENCY LAW DISCLOSURE

Disclosure Regarding Real Estate Agency Relationships

Prepared by: Agent ____________________________ **Phone** ______________________
Broker ____________________________ **Email** ______________________

NOTE: This agency disclosure complies with agency disclosures required with property listings and offers to buy, sell, exchange or lease one-to-four residential units and mobile homes. [Calif. Civil Code §§2079 et seq.]

DATE: ____________, 20______, at ____, California.
TO THE SELLER AND THE BUYER: ____

1. **FACTS:** When you enter into a discussion with a real estate agent regarding a real estate transaction, you should, from the outset, understand what type of agency relationship or representation you wish to have with the agent in the transaction.
2. **SELLER'S AGENT:** A Seller's Agent under a listing agreement with the Seller acts as the Agent for the Seller only. A Seller's Agent or a subagent of that Agent has the following affirmative obligations:
   2.1 To the Seller:
      a. A fiduciary duty of utmost care, integrity, honesty and loyalty in dealings with the Seller.
   2.2 To the Seller and the Buyer:
      a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
      b. A duty of honest and fair dealing and good faith.
      c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of the parties.
   2.3 An Agent is not obligated to reveal to either party any confidential information obtained from the other party which does not involve the affirmative duties set forth above.
3. **BUYER'S AGENT:** A Selling Agent can, with a Buyer's consent, agree to act as the Agent for the Buyer only. In these situations, the Agent is not the Seller's Agent, even if by agreement the Agent may receive compensation for services rendered, either in full or in part, from the Seller. An Agent acting only for a Buyer has the following affirmative obligations:
   3.1 To the Buyer:
      a. A fiduciary duty of utmost care, integrity, honesty and loyalty in dealings with the Buyer.
   3.2 To the Seller and the Buyer:
      a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
      b. A duty of honest and fair dealing and good faith.
      c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to or within the diligent attention and observation of the parties. An Agent is not obligated to reveal to either party any confidential information obtained from the other party which does not involve the affirmative duties set forth above.
4. **AGENT REPRESENTING BOTH THE SELLER AND THE BUYER:** A Real Estate Agent, either acting directly or through one or more associate licensees, can legally be the Agent of both the Seller and the Buyer in a transaction, but only with the knowledge and consent of both the Seller and the Buyer.
   4.1 In a dual agency situation, the Agent has the following affirmative obligations to both the Seller and the Buyer:
      a. A fiduciary duty of utmost care, integrity, honesty and loyalty in the dealings with either the Seller or the Buyer.
      b. Other duties to the Seller and the Buyer as stated above in their respective sections.
   4.2 In representing both the Seller and the Buyer, the Agent may not, without the express permission of the respective party, disclose to the other party that the Seller will accept a price less than the listing price or that the Buyer will pay a price greater than the price offered.
5. The above duties of the Agent in a real estate transaction do not relieve a Seller or a Buyer from the responsibility to protect their own interests. You should carefully read all agreements to assure that they adequately express your understanding of the transaction. A Real Estate Agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional.
6. Throughout your real property transaction, you may receive more than one disclosure form depending upon the number of Agents assisting in the transaction. The law requires each Agent with whom you have more than a casual relationship to present you with this disclosure form. You should read its contents each time it is presented to you, considering the relationship between you and the Real Estate Agent in your specific transaction.
7. This disclosure form includes the provisions of §2079.13 to §2079.24, inclusive, of the Calif. Civil Code set forth on the reverse hereof. Read it carefully.

(Buyer's Broker)	Date	(Buyer's Signature)	Date
(Associate Licensee's Signature)	Date	(Buyer's Signature)	Date
(Seller's Broker)	Date	(Seller's Signature)	Date
(Associate Licensee's Signature)	Date	(Seller's Signature)	Date

— — — — — — PAGE ONE OF TWO — FORM 305 — — — — — —

§2079.13. As used in Sections 2079.14 to 2079.24, inclusive, the following terms have the following meanings:

(a) "Agent" means a person acting under provisions of Title 9 (commencing with Section 2295) in a real property transaction, and includes a person who is licensed as a real estate broker under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code, and under whose license a listing is executed or an offer to purchase is obtained.

(b) "Associate licensee" means a person who is licensed as a real estate broker or salesperson under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code and who is either licensed under a broker or has entered into a written contract with a broker to act as the broker's agent in connection with acts requiring a real estate license and to function under the broker's supervision in the capacity of an associate licensee.

The agent in the real property transaction bears responsibility for his or her associate licensees who perform as agents of the agent. When an associate licensee owes a duty to any principal, or to any buyer or seller who is not a principal, in a real property transaction, that duty is equivalent to the duty owed to that party by the broker for whom the associate licensee functions.

(c) "Buyer" means a transferee in a real property transaction, and includes a person who executes an offer to purchase real property from a seller through an agent, or who seeks the services of an agent in more than a casual, transitory, or preliminary manner, with the object of entering into a real property transaction. "Buyer" includes vendee or lessee.

(d) "Dual agent" means an agent acting, either directly or through an associate licensee, as agent for both the seller and the buyer in a real property transaction.

(e) "Listing agreement" means a contract between an owner of real property and an agent, by which the agent has been authorized to sell the real property or to find or obtain a buyer.

(f) "Listing agent" means a person who has obtained a listing of real property to act as an agent for compensation.

(g) "Listing price" is the amount expressed in dollars specified in the listing for which the seller is willing to sell the real property through the listing agent.

(h) "Offering price" is the amount expressed in dollars specified in an offer to purchase for which the buyer is willing to buy the real property.

(i) "Offer to purchase" means a written contract executed by a buyer acting through a selling agent which becomes the contract for the sale of the real property upon acceptance by the seller.

(j) "Real property" means any estate specified by subdivision (1) or (2) of Section 761 in property which constitutes or is improved with one to four dwelling units, any leasehold in this type of property exceeding one year's duration, and mobilehomes, when offered for sale or sold through an agent pursuant to the authority contained in Section 10131.6 of the Business and Professions Code.

(k) "Real property transaction" means a transaction for the sale of real property in which an agent is employed by one or more of the principals to act in that transaction, and includes a listing or an offer to purchase.

(l) "Sell," "sale," or "sold" refers to a transaction for the transfer of real property from the seller to the buyer, and includes exchanges of real property between the seller and buyer, transactions for the creation of real property sales contract within the meaning of Section 2985, and transactions for the creation of a leasehold exceeding one year's duration.

(m) "Seller" means the transferor in a real property transaction, and includes an owner who lists real property with an agent, whether or not a transfer results, or who receives an offer to purchase real property of which he or she is the owner from an agent on behalf of another. "Seller" includes both a vendor and a lessor.

(n) "Selling agent" means a listing agent who acts alone, or an agent who acts in cooperation with a listing agent, and who sells or finds and obtains a buyer for the real property, or an agent who locates property for a buyer or who finds a buyer for a property for which no listing exists and presents an offer to purchase to the seller.

(o) "Subagent" means a person to whom an agent delegates agency powers as provided in Article 5 (commencing with Section 2349) of Chapter 1 of Title 9. However, "subagent" does not include an associate licensee who is acting under the supervision of an agent in a real property transaction.

§2079.14. Listing agents and selling agents shall provide the seller and buyer in a real property transaction with a copy of the disclosure form specified in Section 2079.16, and, except as provided in subdivision (c), shall obtain a signed acknowledgment of receipt from that seller or buyer, except as provided in this section or Section 2079.15, as follows:

(a) The listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement.

(b) The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form pursuant to subdivision (a).

(c) Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the selling agent may be furnished to the seller (and acknowledgment of receipt obtained for the selling agent from the seller) by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his or her last known address, in which case no signed acknowledgment of receipt is required.

(d) The selling agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase, except that if the offer to purchase is not prepared by the selling agent, the selling agent shall present the disclosure form to the buyer not later than the next business day after the selling agent receives the offer to purchase from the buyer.

§2079.15. In any circumstance in which the seller or buyer refuses to sign an acknowledgment of receipt pursuant to Section 2079.14, the agent, or an associate licensee acting for an agent, shall set forth, sign, and date a written declaration of the facts of the refusal.

§2079.17. (a) As soon as practicable, the selling agent shall disclose to the buyer and seller whether the selling agent is acting in the real property transaction exclusively as the buyer's agent, exclusively as the seller's agent, or as a dual agent representing both the buyer and the seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller, the buyer, and the selling agent prior to or coincident with execution of that contract by the buyer and the seller, respectively.

(b) As soon as practicable, the listing agent shall disclose to the seller whether the listing agent is acting in the real property transaction exclusively as the seller's agent, or as a dual agent representing both the buyer and seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller and the listing agent prior to or coincident with the execution of that contract by the seller.

(c) The confirmation required by subdivisions (a) and (b) shall be in the following form:

________[Do not fill out]________ is the agent of (check one):
(Name of Listing Agent)

☐ the seller exclusively; or

☐ both the buyer and seller.

________[Do not fill out]________ is the agent of (check one):
(Name of Selling Agent if not same as the Listing Agent)

☐ the buyer exclusively;

☐ the seller exclusively; or

☐ both the buyer and seller.

(d) The disclosures and confirmation required by this section shall be in addition to the disclosure required by Section 2079.14.

§2079.18. No selling agent in a real property transaction may act as an agent for the buyer only, when the selling agent is also acting as the listing agent in the transaction.

§2079.19. The payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is not necessarily determinative of a particular agency relationship between an agent and the seller or buyer. A listing agent and a selling agent may agree to share any compensation or commission paid, or any right to any compensation or commission for which an obligation arises as the result of a real estate transaction, and the terms of any such agreement shall not necessarily be determinative of a particular relationship.

§2079.20. Nothing in this article prevents an agent from selecting, as a condition of the agent's employment, a specific form of agency relationship not specifically prohibited by this article if the requirements of Section 2079.14 and Section 2079.17 are complied with.

§2079.21. A dual agent shall not disclose to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller. A dual agent shall not disclose to the seller that the buyer is willing to pay a price greater than the offering price, without the expressed written consent of the buyer.

This section does not alter in any way the duty or responsibility of a dual agent to any principal with respect to confidential information other than price.

§2079.22. Nothing in this article precludes a listing agent from also being a selling agent, and the combination of these functions in one agent does not, of itself, make that agent a dual agent.

§2079.23. A contract between the principal and agent may be modified or altered to change the agency relationship at any time before the performance of the act which is the object of the agency with the written consent of the parties to the agency relationship.

§2079.24. Nothing in this article shall be construed to either diminish the duty of disclosure owed buyers and sellers by agents and their associate licensees, subagents, and employees or to relieve agents and their associate licensees, subagents, and employees from liability for their conduct in connection with acts governed by this article or for any breach of a fiduciary duty or a duty of disclosure.

Scan this QR-Code for a PDF of the Form!

The legislation created an agency scheme in an attempt to cure a number of previously misleading brokerage practices. In doing so, it established uniform real estate terminology and brokerage conduct covering targeted transactions on one-to-four unit residential property. The Agency Law Disclosure form is a succinct restatement of existing agency codes including codified case law on agency relationships.

Additionally, the legislated real estate agency scheme made changes in when and how each broker must proceed to **confirm** his agency relationship with the principals in targeted one-to-four unit residential sales transactions.

Uniform jargon and agency law

Basically, the Agency Law Disclosure form was created by the legislature for use by brokers and their agents to educate and familiarize clientele (as well as the brokers and their agents) with:

- a uniform jargon for real estate transactions; and
- the various agency roles licensees may undertake on behalf of their principals and other parties in a real estate related transaction.

This information is presented in a two-page form, sometimes referred to as the *Rules of Agency* or the *Agency Law Disclosure*. The exact wording of its entire content is dictated by statute. [Calif. Civil Code §2079.16; see Form 305 accompanying this chapter]

The **Agency Law Disclosure** defines and explains, in general terms, many of the words and phrases commonly used in the real estate industry to express:

- the *agency relationships* of brokers to the parties in the transaction;
- *broker-to-broker relationships*; and
- the *employment relationship* between brokers and their agents.

A *buyer's agent* and a *seller's agent* are mentioned but not defined. A "single agent," which is typically a buyer's agent who is paid by the buyer, is not even mentioned.

Legally, an **agent** is a licensed real estate broker. Thus, the word agent, when used in the disclosure, is not a reference to the broker's agents who in fact call themselves "agents." Ironically, in practice, a broker rarely, if ever, refers to himself as an agent, which in law, he is.

However, two sections on the face of the Agency Law Disclosure, entitled "seller's agent" and "buyer's agent," address the duties owed to the seller and buyer in a real estate transaction by these otherwise undefined brokers.

The seller's broker is correctly noted as being an agent for the seller. Peculiar to real estate brokerage, the buyer's broker is sometimes referred to as the *selling agent*.

One then wonders who is the "buying agent" — an unmentioned phrase, but one more plainly descriptive of the activities undertaken by a broker acting as an agent exclusively on behalf of the buyer – hence, **buyer's agent**.

The Agency Law Disclosure does not mention, much less define, the broker's role as an *exclusive agent* for either the buyer or seller. Yet the separate agency confirmation provision mandated to be included in all purchase agreements used on targeted transactions provides the broker with options to characterize himself as the agent of the "seller exclusively" or the "buyer exclusively."

It is certain these exclusive characterizations of agency have absolutely no relationship to exclusive (employment) listings to sell or to buy property. The seller's agent with an exclusive right-to-sell listing needs to understand the prospective buyer may well turn out to be one of his clients, making the broker a "non-exclusive" dual agent.

However, the two sections on the first page of the Agency Law Disclosure entitled "seller's agent" and "buyer's agent" do state, in broad legal terms, generally accepted principles of law governing the conduct of brokers who are acting as agents solely for a seller or a buyer in a transaction. Also presented is the *general duty* of fairness owed the other party and broker in the transaction.

Two categories of **broker obligations** arise in a sales transaction and are properly emphasized in the Agency Law Disclosure:

- the *special or primary agency duties* of an agent which are owed by a broker (and his agents) to his client — being the fiduciary duties of a trustee to his beneficiaries; and

- the *general duties* owed by each broker to all parties in the transaction — to be honest and avoid misleading or deceitful conduct.

Agencies confirmed in the purchase agreement

As part of the same agency disclosure scheme, a separate **agency confirmation provision** is mandated for inclusion in purchase agreement forms used to memorialize targeted transactions. The agency confirmation provision located in a purchase agreement advises the buyer and seller, at the time they sign the purchase agreement or its counteroffer, of any agency relationships each broker has with the parties in the transaction.

The Agency Law Disclosure contains the agency confirmation provision which is required to be included in purchase agreements. However, the provision in the Agency Law Disclosure is not to be filled out or used in lieu of the agency confirmation provision contained in a purchase agreement.

The agencies to be confirmed by each broker in the purchase agreement provisions are not even known at the listing stage. Thus, the agency in a future sales transaction cannot be confirmed at the time the seller is first required to be presented with the Agency Law Disclosure form. [CC §2079.17(d)]

The agency confirmation provision in a purchase agreement is filled out to disclose each broker's actual agency relationship, established by the broker's conduct and the conduct of their agents with the buyer and/or seller. The agency relationship confirmed is the broker's **legal determination** of the actual agency created by his and his agent's prior conduct with the parties.

When two brokers are involved in a targeted transaction, each broker must disclose whether he is acting as the agent for the buyer or the seller. Alternatively, when only one broker is involved, he must confirm whether he and his agents are acting as the exclusive agent for one party or as a dual agent for both the buyer and seller. [See **first tuesday** Form 150]

A broker (or his agents) prudently includes the agency confirmation provision and attaches the Agency Law Disclosure form to all purchase agreements used in the sale of all types of property, not just as mandated for use on targeted one-to-four unit residential sales or leases exceeding one year. Written disclosures tend to eliminate later disputes over agency, which can become the basis for cancelling a purchase agreement, the payment of a brokerage fee, or both. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

Use of the Agency Law Disclosure

The Agency Law Disclosure form is mandated to be presented to all parties, by brokers or their agents, when listing, selling, buying or leasing (for over one year) property containing:

- one-to-four residential units; or
- mobilehomes. [CC §§2079.13(j), 2079.14]

However, not all transactions involving one-to-four unit residential properties are **targeted** to require the attachment of the Agency Law Disclosure or the inclusion of the agency confirmation provision in purchase agreement forms. Arranging the secured interests of lenders and borrowers under trust deeds or as collateral loans, for example, are not targeted transactions.

The sale, exchange or creation of interests in residential property transactions targeted by the agency disclosure law include transfers of:

- fee simple estates in real estate or registered ownerships for mobilehomes;
- life estates;
- existing leaseholds with more than one year remaining, such as ground leases; and
- leases created for more than one year. [CC §2079.13(l)]

The Agency Law Disclosure must be attached to the following documents and signed by all parties in targeted transactions:

- a seller's listing;
- a purchase agreement offer and acceptance;
- an exchange agreement;
- a counteroffer, by attachment or by reference, to a purchase agreement containing the disclosure as an attachment;
- a landlord's authorization to a broker to lease property on his behalf for more than one year; and
- a residential lease agreement for a period exceeding one year. [CC §2079.14]

Negotiations and agreements on one-to-four residential units concerning buyers' listings, property management (unless entry into leases for periods exceeding one year are authorized), purchase options, financing arrangements, one-year leases and month-to-month rental agreements **do not yet require** statutory disclosure of the broker's agency.

Editor's note — However, the Agency Law Disclosure is to be handed to a buyer as an addendum to the buyer's purchase agreement offer.

Agency rules for a seller's listing

A seller's listing, open or exclusive, employing a broker and his agents to sell a one-to-four unit residential property is a targeted transaction requiring the inclusion of the Agency Law Disclosure as an addendum to the seller's listing agreement. [CC §2079.14(a)]

Failure of the seller's agent to provide the seller with the Agency Law Disclosure prior to his entering into the listing agreement will result in the broker's loss of his fee on a sale, if challenged by the seller. The loss of the fee is not avoided by a later disclosure made as an addendum to a purchase agreement or escrow instructions. [**Huijers** v. **DeMarrais** (1992) 11 CA4th 676]

The Agency Law Disclosure is also required to be used by agents listing and submitting offers regarding leasehold estates involving one-to-four unit residential property. These transactions occur when a long-term ground lease is being conveyed to a buyer and will be security for any purchase-assist financing. [CC §§2079.13(j), 2079.13(l), 2079.14]

Also, the seller's signature is required on the Agency Law Disclosure to **acknowledge receipt** of a copy at both:

- the listing stage, as an addendum to the listing; and

- on presentation of a buyer's offer, as an addendum to the purchase agreement. [CC §2079.14]

Thus, the Agency Law Disclosure is to be treated by the seller's agent as a preliminary and compulsory listing event since the seller's broker expects to collect a brokerage fee on a later sale. The Agency Law Disclosure is signed by the seller and handed back to the broker (or his agent) before settling down to finalize the listing to which it will be attached.

When the broker (or his sales agent) fails to hand the seller the Agency Law Disclosure at the listing stage, the listing, and thus the agency, can be later cancelled by the seller at any time. The seller can cancel even after the transaction sought under the listing agreement is in escrow and the brokerage fee has been further agreed to and the Agency Law Disclosure has been delivered with the purchase agreement and escrow instructions.

On the other hand, the buyer's broker *perfect*s his right to collect his portion of any brokerage fee, when the buyer's broker's share of the fee is payable directly to the buyer's broker by the seller, by including the Agency Law Disclosure as a signed addendum to his purchase agreement offer. However, the buyer's broker might erroneously agree to initially let the seller's broker receive the entire fee from the seller. Here the seller's broker would then pay the buyer's broker his share of the fee under a fee-sharing agreement.

But when the seller's broker fails to obtain a signed Agency Law Disclosure as an addendum to the listing, the seller may legally avoid paying the seller's broker the fee. Thus, when the seller has not agreed to directly pay the buyer's broker, the seller's refusal to pay his broker the entire fee for lack of a timely disclosure leaves the buyer's broker without a fee as agreed from the seller's broker.

For the buyer's broker to protect his fee, the seller must agree in the body of the purchase agreement offer signed by the buyer that the seller will pay both brokers himself. The buyer's broker always takes control over the payment and *perfects* the right to collect his fee when the buyer's agent includes a fee provision in the purchase agreement offer made by his buyer.

Chapter 3 — Agency confirmation provision

This chapter examines the use of the agency confirmation and broker/agent identification provisions in the purchase agreement.

For a further discussion of this topic, see Chapter 3 of the "Agency" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 3 Outline

Mandated for purchase agreements
Use of the agency confirmation provision

Chapter 3 Terms

Agency law disclosure	*Double-ended deal*
Associate licensee	*Fiduciary agency*
Buyer's broker	*Statutory definition*
Confirmation of agency	

Mandated for purchase agreements

The agency relationship of brokers and their agents to their principals is required to be made to all parties in a sale, exchange or long-term lease transaction on one-to-four unit residential property, called a *confirmation of agency*.

The agency confirmation is made in a provision located within all purchase agreement offers on a one-to-four unit residential property, typically signed first by the buyer and then submitted to the seller. [Calif. Civil Code §2079.17; see Figure 1]

The agency confirmation provision states the existence or nonexistence of each broker's fiduciary agency with the various parties to the transaction, sometimes called a *specific agency* as opposed to the general agency duty owed all parties in a transaction. The **determination and declaration** by a broker (or by an agent on his behalf) of the agency resulting from the broker's conduct and that of his agents is made by each broker involved. Each broker identifies the party he is acting on behalf of as their agent in the transaction.

Thus, one broker does not state the agency relationship of any other broker involved in the transaction. For example, the buyer's broker preparing an offer need not include the seller's broker's agency when he fills out his agency confirmation and broker identification provisions in the purchase agreement form. [CC §2079.17(a)]

Figure 1 *Excerpt from **first tuesday** Form 150*

Purchase Agreement (One-to-Four Residential Units – Conventional and Carryback Financing)

Buyer's/ Selling Broker: ________	Seller's/ Listing Broker: ________
Broker's DRE Identification #: ________	Broker's DRE Identification #: ________
Selling Agent: ________	Listing Agent: ________
Agent's DRE Identification #: ________	Agent's DRE Identification #: ________
Signature: ________	Signature: ________
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: ________	Address: ________
Phone: ________ Cell: ________	Phone: ________ Cell: ________
Fax: ________	Fax: ________
Email: ________	Email: ________

Scan this QR-Code for a PDF of the Form!

Also, each time any broker prepares a purchase agreement offer on a one-to-four unit residential property, confirming his specific agency in the transaction, an *agency law disclosure form* will also be attached as a referenced addendum. The agency law disclosure must be presented to the buyer before the buyer signs the purchase offer. Further, the agency law disclosure addendum must be signed by the buyer and then signed by the seller on an acceptance of the offer or submission of a counteroffer.

The **agency law disclosure** addendum is an explanation of the duties owed each party in a sales transaction by the broker and agents involved. [CC §2079.17(d); See Chapter 2]

Use of the agency confirmation provision

Both the agency confirmation provision in purchase agreements and the separate agency law disclosure are required as part of a purchase agreement on all *offers and acceptances* negotiated by brokers to buy, sell, exchange, or lease for more than one year, property that includes one-to-four residential units or mobilehomes. [CC §2079.17(d)]

In practice, the buyer's agent is the broker or his agent who prepares and presents a purchase agreement offer to the buyer for his signature.

Thus, the **buyer's broker**, himself or through his sales agent, will:

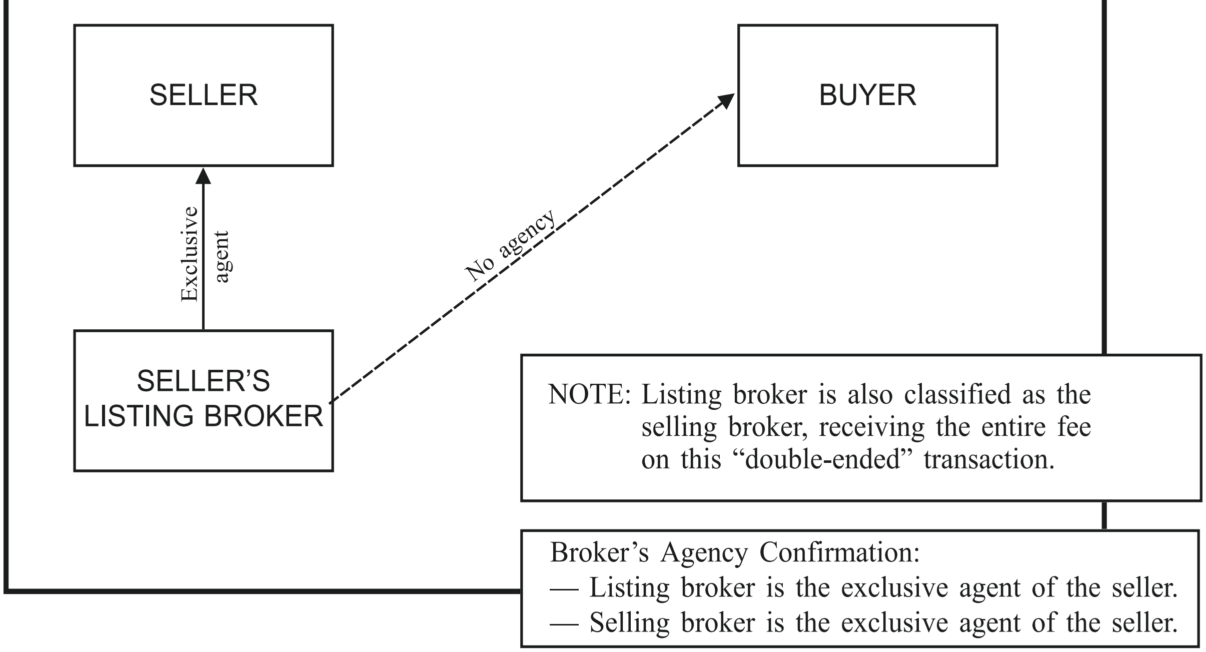
- attach the agency law disclosure form as an addendum to the purchase agreement;
- fill out the buyer's agent's agency confirmation provision in the purchase agreement; and
- obtain the buyer's signature on the agency law disclosure and the purchase agreement.

Before submitting the buyer's purchase agreement to the seller, the seller's broker on receiving an offer needs to fill out the seller's broker confirmation noting the agency relationship established by his conduct with the seller.

If the seller's **counteroffer** incorporates all the provisions of the buyer's offer into the counteroffer form, as most all do, the seller has signed a writing which includes (by reference) the confirmation of the broker's agencies. All the seller need sign is the counteroffer and the agency law disclosure, since the purchase agreement offer has been rejected and need never be signed.

Figure 2 **Buyer shown only "in-house" listings**

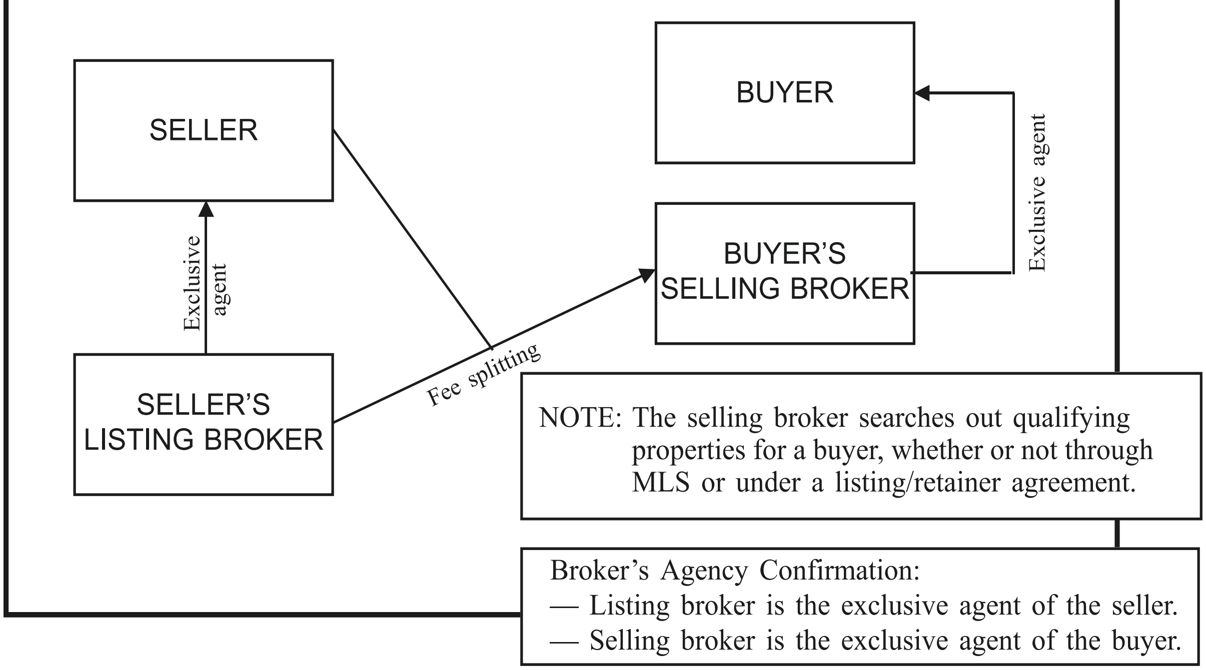
(No duty undertaken to investigate "other brokers' " listings)



NOTE: Listing broker is also classified as the selling broker, receiving the entire fee on this "double-ended" transaction.

Broker's Agency Confirmation:
— Listing broker is the exclusive agent of the seller.
— Selling broker is the exclusive agent of the seller.

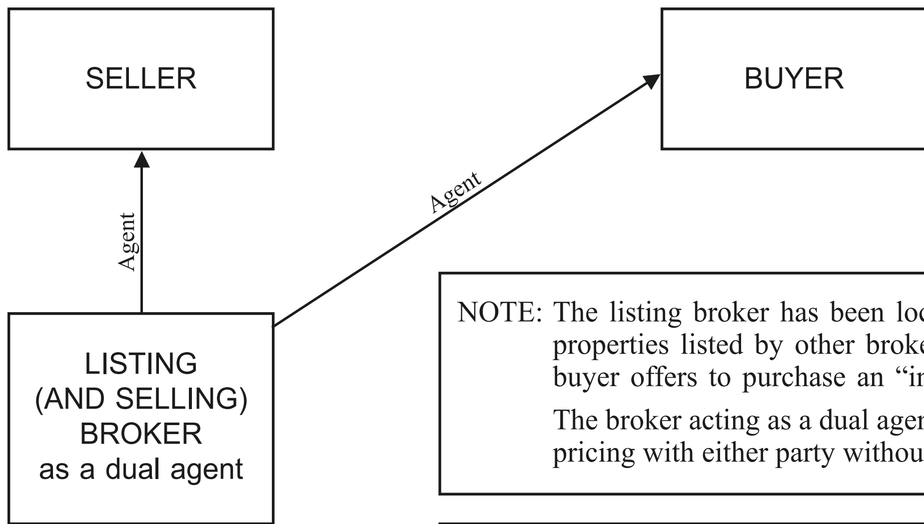
Figure 3 **Property listed by another broker is located for a buyer by the selling broker**



NOTE: The selling broker searches out qualifying properties for a buyer, whether or not through MLS or under a listing/retainer agreement.

Broker's Agency Confirmation:
— Listing broker is the exclusive agent of the seller.
— Selling broker is the exclusive agent of the buyer.

Figure 4 **Buyer purchases listed property after being shown "other brokers' " listings**

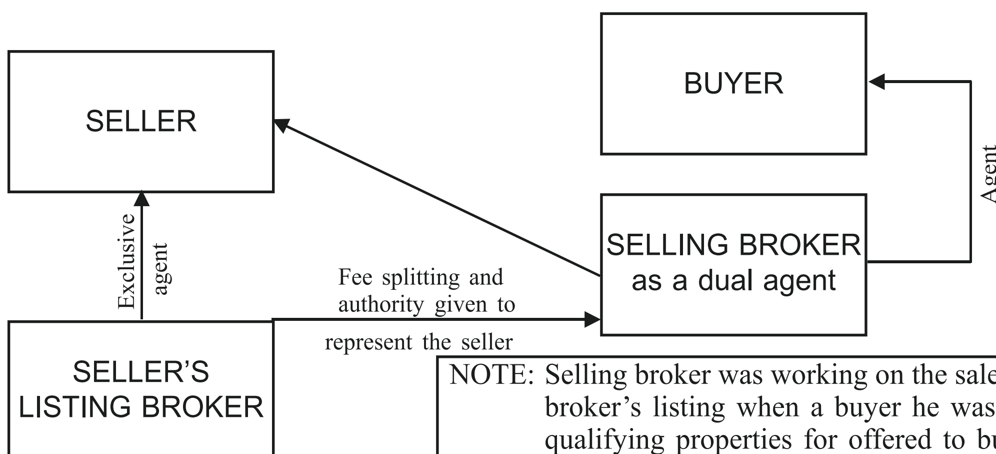


NOTE: The listing broker has been locating qualifying properties listed by other brokers when the buyer offers to purchase an "in house" listing.

The broker acting as a dual agent cannot discuss pricing with either party without written consent.

Broker's Agency Confirmation:
— Listing broker is the agent of both buyer and seller.
— Selling broker is the agent of both buyer and seller.

Figure 5 **Selling broker locating buyer for another broker's listing while locating property for buyer**



NOTE: Selling broker was working on the sale of another broker's listing when a buyer he was locating qualifying properties for offered to buy it.

Selling broker cannot discuss pricing with either party without written consent.

Broker's Agency Confirmation:
— Listing broker is the exclusive agent of the seller.
— Selling broker is the exclusive agent of both

Chapter 4 — Subagency and dual agency

This chapter analyzes the conduct of a subagent in contrast to the conduct of a dual agent, and distinguishes fee-sharing/broker-cooperation arrangements from both.

For a further discussion of this topic, see Chapter 4 of the "Agency" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 4 Outline

An MLS membership myth
Subagent vs. fee-sharing buyer's broker
Dual agency as an authorized practice
Dual agency and conflict of interest
Both clients are entitled to advice
Dual agency and diminished benefits

Chapter 4 Terms

Conflict of interest	*Modification of listing*
Dual agency	*Multiple listing service (MLS)*
Exclusively represented	*Subagency*
Legal agent	

An MLS membership myth

The *multiple listing service (MLS)* is an association of real estate licensees who agree to the pooling of listings and the sharing of fees. The **MLS** facilitates cooperation by enabling agents of sellers, also known as *listing agents*, to quickly disseminate listing and property information to agents of buyers, also referred to as *selling agents*.

However, the mere membership of a buyer's broker in a MLS never creates a dual agency or subagency relationship with any seller whose property is listed for sale with other brokers in the MLS.

Agency, whatever the type, is created either by **contract** or by the **conduct of each broker** (and his agents) when interacting with a buyer or seller, not by trade memberships or the seller's payment of the broker fee. [Calif. Civil Code §2307]

Subagency duties differ greatly from those misleading subagency concepts generated at the MLS level. "MLS subagency" arose out of notions held about the nature of *cooperation* between brokers in fee-sharing arrangements. The focus within the MLS for determining agency relationships in the past was improperly placed on the relationship between the MLS brokers.

The analysis overlooked the principal - broker relationships in sales transactions.

For example, when an MLS buyer's broker (erroneously) believes he is a "subagent" in a transaction on property another broker has listed in the MLS, the critical brokerage facts will include:

- the buyer's broker is an MLS member;
- the broker or one of his agents is assisting a buyer in locating qualifying properties for the purpose of purchasing one which is suitable;
- the broker or his agent has prepared a purchase offer for the buyer to acquire property listed with another broker who is also an MLS member; and
- the brokerage fee due the broker will be paid from funds accruing to the seller based on the seller's broker MLS listing information offering to share his fee with any broker-member who submits an offer at the listed price.

Here, the buyer's broker does not become a subagent of the seller due to the sharing of the fee. To become a subagent he must **conduct himself** as the seller's representative throughout all negotiations with the buyer and undertaking no agency duties to represent (care for) and negotiate (protect) on behalf of the buyer.

It is instructive to observe that a buyer's broker shares fees with the seller's broker, not duties. Also, the buyer's broker is not mandated to perform a **visual inspection** and disclose his observations on behalf of the seller as required of seller's agents, legal subagents and dual agents.

Subagent vs. fee-sharing buyer's broker

A seller's listing agreement authorizes the seller's broker to cooperate (share property information) with other brokers and to divide with them any brokerage fee due under the listing. [See **first tuesday** Form 102 §4.2]

Today, listing agreements no longer include wording which also authorizes the seller's broker to delegate to other brokers the authority to **also act** on behalf of the seller as the seller's agent to **locate buyers** and obtain offers to purchase. When another broker also acts on behalf of a seller he has legally established a *subagency* with the seller, not an agency employment with the seller's broker.

However, should a provision in a listing agreement actually authorize the seller's broker to create a subagency between his seller and another broker, the seller's broker may then act on behalf of the seller to employ another brokerage office as a *subagent* to also act on behalf of the seller to market the property.

Subagency facts in a purchase agreement setting include:

- two separate brokers, one being the seller's broker and the other broker being the **buyer's broker**, referred to legally as a *selling broker,* since he is the broker who has contact with the buyer;

- a seller who is *exclusively represented* by the seller's broker; and

- a buyer who is *not represented* by the buyer's broker (and may or may not be represented by yet another broker).

Dual agency as an authorized practice

Simply put, a *dual agent* is a broker who is simultaneously acting as the fiduciary agent having undertaken the duty to represent the best interest of each of the **opposing parties** in a transaction, e.g., both the buyer and the seller. [CC §2079.13(d)]

The problem with dual agents is not that dual agency is improper. Dual agency has always been and is proper brokerage practice since the situation arises naturally in the course of representing buyers and sellers – brokerage. What is improper is the failure to promptly and continuously disclose the existence of a dual agency (see **first tuesday** Form 120 for prompt disclosure in the agency confirmation provision of a purchase agreement and for a one-to-four unit residential property). [CC §2079.17]

Further, a broker soliciting or negotiating any type of real estate transaction who fails to promptly disclose his dual agency at the moment it arises is subject to:

- the loss of his brokerage fee;

- liability for his clients' money (monetary) losses; and

- disciplinary action by the Department of Real Estate (DRE). [Calif. Business and Professions Code §10176(d)]

Dual agency and conflict of interest

A broker's or his agent's dual agency activity cannot go undisclosed since the situation is replete with potential overlaps of allegiance or prejudice which are a *conflict of interest* for the broker.

A **conflict of interest** exists when:

- a broker has a positive or negative *bias* toward the opposing party in a transaction or a person indirectly involved in the client's transaction; and

- that *bias* in favor of or against the other person might compromise the broker's ability to freely recommend action or provide guidance to the buyer or seller, landlord or tenant, or lender or broker he agreed to represent.

Viewed another way, **conflict of interest** arises when:

Do I have to be a member of the trade union to access the MLS?

Many real estate licensees wrongly believe they must join the *National Association of Realtors (NAR)*, the *California Association of Realtors (CAR)* or the local *Association of Realtors (AOR)* branch of CAR to practice real estate in California, too often equating these trade union leviathans to the Department of Real Estate (DRE) due to their past close liaison.

Other licensees have a slightly better grasp on the implications of membership or non-membership in the real estate trade union versus DRE licensing, but still mistakenly believe that union membership is necessary in order to access their local **multiple listing services (MLS).**

This impression is not unfounded. Before 1976, most real estate trade union boards owned and required all access to the MLS to include membership in their association. Such practice was prohibited in 1976. [**Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920]

Palsson prohibited making association membership a requirement for MLS access to the marketplace. The association was allowed to exact a "reasonable fee" from nonmembers, derogatorily called *Palsson members,* for MLS access. Of course, the bundling continued with the AORs claiming ownership of data behind all the published listings, giving access only to their card-carrying members.

However, **trade union membership** is not required to practice real estate and it is not required to access an MLS. Give your local association a call — they know the rules.

To access an AOR-owned MLS, an individual must:

- have a valid California real estate license;
- be a broker, or a sales agent under a broker who is a member of the MLS;
- apply for access to the MLS; and
- pay a fee, which varies by AOR.

If an agent's broker is not a member of an AOR, the agent is not required to be a member of an AOR. However, if a broker is a member of an AOR, his agents must also be members of the AOR in order to access the broker's MLS.

No other restrictions apply. Real estate agents and brokers can continue to access an MLS without paying excessive and unnecessary dues or entangling themselves in a trade union's bureaucracy, codes and arbitration rules.

Knowledge is power — and this case, money saved.

- a broker or his agent, acting on behalf of a client, has a competing professional or personal bias; and
- the bias hinders his ability to unreservedly fulfill the fiduciary duties he has undertaken to advise and act on behalf of the client.

The existence of a conflict of interest creates a *fundamental agency dilemma* for brokers.

A broker or his agent manages his conflict of interest when acting as a dual agent by disclosing his dual agency to all parties prior to providing a buyer with information on a property listed with the broker or taking a listing from a seller knowing he has a buyer ready to make an offer.

The disclosure creates transparency allowing the clients to take any bias into consideration in further discussion with the broker or his agents and in negotiations with the opposing party. Though the disclosure and consent to the dual agency does not neutralize the inherent bias itself, it does neutralize the element of deceit which if left undisclosed would be a breach of the broker's fiduciary duty.

Both clients are entitled to advice

A rule of sorts for disclosure of relevant facts about the transaction, known to the dual agent before or after acceptance of an offer, is to advise both parties of the facts by written memorandum, and keep a copy of the memo in the transaction file.

However, when a **dual agency** is established in a one-to-four unit residential sales transaction, and both parties are represented by the same broker, the broker (and his agents) may not pass on confidential pricing information such as the price the buyer is willing to pay to the seller or the price the seller is willing to accept from the buyer. Confidential pricing information must remain the undisclosed knowledge of the dual agent, unless authorized to release the information in a writing signed by the principal in question. [CC §2079.21]

Thus, without authorization to disclose confidential pricing information, the dual agent is now a "secret agent." He must keep secret the minimum pricing sought by the seller and the maximum pricing obtainable from the buyer.

The decision not to release pricing information must be made and maintained from the moment the dual agency arises. The dual agency conflict typically arises when the buyer is an existing client and is exposed to property listed by the broker. This conflict of dual agency always occurs before the purchase agreement is prepared and its agency confirmation provision is filled out. It is at the moment the conflict arises that it must be disclosed no later than the time the purchase agreement is prepared and submitted.

The written authority needed to advise the seller of the buyer's willingness to pay more, or the seller's willingness to accept less, is best documented on a **modification of listing** form signed by the client whose confidential pricing information is to be released to the other client. The authority would be given to the broker who would retain the document in his file. [See **first tuesday** Form 120]

Dual agency and diminished benefits

While a broker owes his client the duty to pursue the *best business advantage* legally and ethically obtainable through negotiations and agreements, the dual agent is foreclosed from achieving this advantage for either client. The dual agent cannot take sides with one or the other during negotiations.

Generally, the clients of a dual agent do not receive the full range of benefits they would have obtained from an exclusive agent. The conflicts which exist in a broker's dual representation rule out aggressive negotiations to obtain the best business advantage for either party. This holds true even if different (listing and selling) agents employed by the **same broker** each work with different parties to the same transaction.

Thus, a natural inability exists to negotiate the highest and best price for the seller, and at the same time, negotiate the lowest and best price for the buyer.

The *legal agent* for a buyer or seller in a transaction is the broker, not the broker's agents or brokers employed by the broker who is in contact with the principals. Inhouse transactions which involve the broker as a dual agent make it particularly difficult for the broker to **oversee and supervise** dual agency negotiations.

Typically, one agent employed by the broker acquires a property listing from a seller while another agent in the broker's employ works separately with a buyer to locate qualifying properties whether listed with his or other brokers.

The broker becomes a dual agent the moment the buyer is then shown an in-house listing.

However, an improper tendency in transactions involving only one broker and two of his agents who are separately working with a seller and buyer in a sale is to automatically designate the broker as a dual agent.

In fact, the buyer may well be a party to whom no agency duties are owed by any broker or agent.

For example, the buyer may have simply responded to the broker's "For Sale" sign, open house or ads marketing a listed property. And without first or also being shown unlisted properties or properties listed with other brokers, the buyer makes an offer on an "in-house" listing through an (a buyer's) agent employed by the broker who is not the seller's agent.

When the buyer's inquiry and review of properties is limited to properties listed with the broker, the sale of an in-house listing to a buyer who has not retained this broker to represent him does not, without more, create an agency relationship with the buyer. [**Price** v. **Eisan** (1961) 194 CA2d 363]

However, there remains, as always, the seller's broker's *general nonfiduciary duty* owed to all parties in the transaction, including the non-client buyer, to disclose material facts about the listed property to all parties.

Facts to be voluntarily disclosed by the seller's agent include the property's physical conditions, and the natural and environmental hazards of the location and any other information or data that may have an adverse effect on the value or might otherwise affect the buyer's decision regarding his to purchase of the property.

Further, there are always the additional disclosures made which must be made in good faith by the agents in response to any inquiry by the buyer.

Chapter 5

Real estate licensing and endorsement

This chapter discusses the role of the Department of Real Estate (DRE) in California real estate practice, activities requiring a real estate license and broker/agent licensing and renewal requirements.

Chapter 5 Outline

The Department of Real Estate oversight
Real Estate Commissioner
Activities requiring a real estate license
Delegated supervision, not agency
Licensing and education
Citizenship or residency
The individual broker license
Qualifying for a broker license
Exemptions from license requirements
Continuing education requirements
The corporate license
Partnerships
Fictitious business name
Prepaid rental listing service
Mineral, oil and gas
Child support obligations
Business opportunities
Bulk sales
Mobilehome sales
Mortgage loan brokerage
Brokers who originate loans must have a license endorsement
Background information from applicants
Education requirements for licensing or endorsement
Continuing education for MLOs

Chapter 5 Terms

Bulk Sale
Continuing education
Department of Real Estate
Fictitious business name
Mortgage loan originator
Nationwide Mortgage Licensing System and Registry
Prepaid Rental Listing Service
Real Estate Commissioner
Real Estate Settlement and Procedures Act
SAFE Act

The Department of Real Estate oversight

Real estate law is codified protect the public in real estate transactions when a real estate licensee or subdivision is involved. [Calif. Business and Professions Code §§10000 et seq.]

The California Legislature created the *Department of Real Estate (DRE)* to oversee, regulate, administer and enforce the real estate law.

Real Estate Commissioner

The chief officer of the DRE is called the *Real Estate Commissioner*. The **Real Estate Commissioner's** principal responsibility is to enforce all the real estate laws pertaining to real estate licensing and the Subdivided Lands Act. The Commissioner is appointed by the state governor. [Bus & P C §§10050; 10051]

The Commissioner ensures that real estate licensees and members of the public dealing with licensees receive maximum protection. [Bus & P C §10050]

As a means of enforcing licensing and subdivision laws, the Commissioner issues regulations. The regulations are part of the California Code of Regulations known as Title 10.

Activities requiring a real estate license

To engage in the business of real estate or as a real estate **broker** or **agent,** a person must first obtain a real estate license issued by the DRE. [Bus & P C §10130]

A *real estate broker* is a person who, for compensation or in expectation of compensation, engages in:

- negotiating the sale, purchase or exchange of real estate, leases or business opportunities;
- soliciting listings, buyers or sellers;

Department of Real Estate (DRE) contact information

www.dre.ca.gov

Sacramento 2201 Broadway, Sacramento, CA 95818 (916-227-0931)

Fresno 2550 Mariposa Mall, Room 3070, Fresno, CA 93721 (559-445-2273)

Los Angeles 320 West 4th Street, Suite 350, Los Angeles, CA 90013 (213-620-2072)

Oakland 1515 Clay Street, Suite 702, Oakland, CA 94612 (510-622-2552)

San Diego 1350 Front Street, Suite 1063, San Diego, CA 92101 (619-525-4192)

- leasing or renting, or offering to lease or rent, property on behalf of an owner or tenant;
- collecting rent from real estate or business opportunities;
- assisting in the purchase or lease of property owned by the state or federal government;
- negotiating real property sales contracts, also called a *land sales contract,* or loans to be secured directly or collaterally by real estate or business opportunities on behalf of lenders or borrowers; and
- negotiating the sale or purchase of a mobilehome. [Bus and P C §10131]

A *real estate agent,* also called an *agent* or just *agent,* is a person who, for compensation or in expectation of compensation, is **employed** by a licensed broker to do one or more of the acts of a licensed broker. [Bus & P C §10132]

Real estate agents are legally classified as *agents of the agent*, since they must be e**mployed** by a real estate broker to render real estate-related services to the public. Agents render all services on behalf of the broker that employs them.

Department of Real Estate (DRE) website:
www.dre.ca.gov

Delegated supervision, not agency

A sales agent employed by a broker is the agent of the broker, not a client. In turn, the broker is the agent of the client.

As an agent representing the broker, a real estate sales agent is authorized to prepare listings, sales documents, disclosure sheets, etc., on behalf of the broker. The agent does not do so on his own behalf.

The broker employing agents is required under the DRE's **supervisory scheme** to *reasonably supervise* sales agents' activities. **Reasonable supervision** includes establishing policies, rules, procedures and statements to review and manage:

- transactions requiring a real estate license;
- documents having a material effect upon the rights or obligations of a party to the transaction;
- the filing, storage and maintenance of documents;
- the handling of trust funds;
- advertisement of services that require a license;
- sales agents' knowledge of anti-discrimination laws; and
- reports of the activities of the sales agents. [Department of Real Estate Regulation §2725]

Licensing and education

To be eligible for a broker or agent license, the applicant must:

- be at least 18 years old [DRE Regs. §§2720; 2750];
- be honest and truthful;
- provide proof of legal presence in the U.S.;
- make the application on the proper form prescribed by the DRE;
- complete the mandatory education; and
- pass the qualifying exam.

In addition, all applicants must be fingerprinted. Fingerprints are not required if the applicant is currently licensed by the DRE or holds a real estate license that expired less than two years ago.

All statutory course requirements for both the agent and the broker license may be waived if the applicant is a member of the state bar. [Bus & P C §§10153.2]

Citizenship or residency

All persons applying for an original real estate license must submit proof of citizenship or legal residency to the DRE. Proof of citizenship or residency must also be submitted on the renewal of a license if proof wasn't previously submitted. [DRE Reg. §2718]

Documents to show citizenship or residency include a copy of a birth certificate, U.S. passport, green card, etc. A complete list of the appropriate documents that may be presented is available from the DRE.

For persons who are U.S. citizens or permanent legal residents, the documentation need only be filed with the DRE once. However, a resident alien without permanent status must file the documentation with each renewal.

The individual broker license

Every real estate broker must have and maintain a definite place of business which serves as an *office.* The **office** is the place where the broker displays his license and where consultations with clients are held.

If more than one place of business is maintained, the broker must apply for and obtain an additional license for each branch office he maintains.

Qualifying for a broker license

An agent who has held a real estate agent license for at least two years within the last five years may apply for a broker license.

The agent is required to have worked on a full-time basis (at least 40 hours per week) as an agent during the two-year time requirement.

The DRE requires verification of the agent's employment using the **Employment Verification Form** issued by the DRE. [See the DRE's Employment Verification Form (DRE 226)]

Exceptions to the agent employment requirements will be given to an applicant who has:

- at least two years of general real estate experience; or
- graduated with a degree from a four-year college or university.

The California real estate salesperson and broker examination*

The DRE broker and agent licensing examination consists of seven major areas of real estate practice, divided as follows:

1 — Property Ownership and Land Use Controls and Regulations

Approximately 18% of the sales exam and 15% of the broker exam.

- classes of property;
- property characteristics;
- encumbrances;
- types of ownership;
- descriptions of property;
- government rights in land;
- public controls;
- environmental hazards and regulations;
- private controls;
- water rights; and
- special categories of land.

2 — Laws of Agency

Approximately 12% of the sales exam and 12% of the broker exam.

- law, definition and nature of agency relationships, types of agencies, and agents;
- creation of agency and agency agreements;
- responsibilities of agent to seller/buyer as principal;
- disclosure of agency [See **first tuesday** Form 305];
- disclosure of acting as principal or other interest;
- termination of agency; and
- commission and fees.

3 — Valuation and Market Analysis

Approximately 12% of the sales exam and 11% of the broker exam.

- value; and
- methods of estimating value.

4 — Financing

Approximately 13% of the sales exam and 13% of the broker exam.

- general concepts;
- types of loans;
- sources of financing;
- how to deal with lenders;
- government programs;
- mortgages/deeds of trust/notes;
- financing/credit laws; and
- loan brokerage.

5 — Transfer of Property

Approximately 9% of the sales exam and 10% of the broker exam.

- title insurance;
- deeds;
- escrow;
- reports;
- tax aspects; and
- special processes.

6 — Practice of Real Estate and Mandated Disclosures

Approximately 24% of the sales exam and 27% of the broker exam.

- trust account management;
- fair housing laws;
- truth in advertising;
- record keeping requirements;
- agent supervision;
- permitted activities of unlicensed sales assistants;
- DRE jurisdiction and disciplinary actions;
- licensing, continuing education requirements and procedures;
- california Real Estate Recovery Fund;
- general ethics;
- technology;
- property management/landlord-tenant rights;
- commercial/industrial/income properties;
- specialty areas;
- transfer disclosure statement (TDS) [See **first tuesday** Form 304];

- natural hazard disclosure (NHD) statements [See **first tuesday** Form 314];
- material facts affecting property value; and
- need for inspection and obtaining/verifying information.

7 — Contracts

Approximately 12% of the sales exam and 12% of the broker exam.

- general;
- listing agreements;
- buyer broker agreements;
- offers/purchase contracts;
- counteroffers/multiple counteroffers;
- leases; and
- agreements.

*See the DRE's ***Reference Book: Information Relating to Real Estate Practice, Licensing and Examinations****. This publication is available on the ****first tuesday Unlocking the DRE Exam – Your Quickstart Career Kit**** Bonus CD-ROM.*

To qualify for the employment exemption based on experience, the broker applicant must file a written petition with the DRE setting forth the applicant's qualifications. [See the DRE's Equivalent Experience Verification Form (DRE 227)]

The DRE considers the following activities, conducted within the five-year period immediately prior to the date of application for the broker examination, as qualification in lieu of employment as a sales agent:

- experience as an escrow or title officer;
- experience as a loan officer directly related to the financing or conveying of property;
- experience as a subdivider, contractor or speculative builder, if the agent performed substantial duties relating to the purchase, finance, development and sale or lease of real property.

Other types of direct real estate-related experience will be considered by the DRE if it satisfies the intent of the law. [See the DRE's *Instructions to License Applicants*, July 2009]

All **broker applicants** must complete eight statutory courses of three-semester units or the quarter equivalent, unless exempt.

Five of the eight courses must be in:

- real estate practice;
- legal aspects of real estate;
- real estate appraisal;
- real estate finance; or
- real estate economics or accounting. [Bus & P C §10153.2(a)(1)]

The remaining three courses can be selected from any of the following:

- real estate principles;
- business law;
- property management;
- real estate office administration;
- escrows;
- mortgage loan brokering and lending;
- advanced legal aspects of real estate;
- common interest developments (CIDs);
- advanced real estate finance;
- advanced real estate appraisal; or
- computer applications in real estate. [Bus & P C §10153.2(a)(2)]

The three courses taken to meet the agent licensing requirements count towards the eight courses a broker must take. Thus, a licensed agent must only take five additional courses to qualify to take the broker exam.

On completion of the course requirements, the broker may apply to take the broker exam. If the broker applicant is not qualified at the time of the application, the applicant will be notified by the DRE of his failure to qualify.

The applicant has **two years** from the DRE receipt of the examination application to meet the license qualification requirements and take the exam.

If the broker applicant fails the exam, the applicant may apply for reexamination but must do so within two years after filing the examination application. No limit is placed on the number of times the applicant may take the exam.

Once the applicant has been notified by the DRE he has passed the exam, the applicant must apply for a broker license and pay the appropriate licensing fee within one year of passing the exam.

Agent license

An agent is an individual employed by a real estate broker to directly participate in brokerage activities on the broker's behalf.

To qualify to take the real estate agent license DRE exam, an applicant must complete a three-semester unit course, or the quarter equivalent, in:

- real estate principles;
- real estate practice; and
- one elective course in the following subjects:

DRE licensing and renewal fees

Examinations and Exam/License Applications

Broker		**Agent**	
Examination fee	$95	Examination fee	$60
Broker 1st reschedule	$20	Agent 1st reschedule	$15
Broker subsequent reschedule	$30	Agent subsequent reschedule	$30

Original Exam/License Applications and Corporation License Applications

Original Broker/Corporation License	$300
Original Agent License	$245

Renewal License Applications

Broker/Corporation renewing on-time	$300
Broker/Corporation renewing late	$450
Agent renewing on-time	$245
Agent renewing late	$367

- legal aspects of real estate;
- real estate finance;
- property management;
- real estate appraisal;
- real estate economics or accounting;
- business law;
- real estate office administration;
- escrows;
- mortgage loan brokering and lending;
- common interest developments (CIDs); or
- computer applications in real estate. [Bus & P C §10153.4]

The applicant has two years from the date the exam application is filed with the DRE to take the exam. [Bus & P C §10153.8]

An applicant who fails to take the exam and pass within two years from the date of filing the application will have to file a new application to take the exam.

An applicant who fails the agent exam may apply for reexamination. No restriction exists on the number of times the applicant may take the test within the two-year period following the application. [Bus & P C §10153.8]

Once the DRE notifies the applicant of passing the exam, the applicant may apply for an agent license. The application for the license and the fee must be submitted to the DRE within one year of the examination date.

Exemptions from license requirements

The following are major categories of persons and activities which are exempt from real estate licensing requirements:

- a person dealing with their own property, called a *principal*;

- an officer of a corporation, or a general partner of a partnership or a manager of a limited liability company (LLC), collectively called *entities,* with respect to property owned or leased by the entity. To be exempt, the acts may not be performed in expectation of a fee;
- an individual with power-of-attorney authority;
- an attorney rendering legal services for a client;
- a receiver, trustee in bankruptcy or any person acting under order of a court;
- a trustee of a trust deed lien who is acting under a power-of-sale provision in the trust deed [Bus & P C §10133]; or
- a resident manager of an apartment complex, hotel, motel or trailer park. [Bus & P C §10131.01]

Also exempt are individuals acting on behalf of others, such as **unlicensed employees** of real estate brokers, who arrange, accept reservations or money for transient occupancy in:

- vacation rentals such as hotels, motels or residence clubs;
- common interest developments (CIDs), such as condominium projects, planned urban developments (PUDs), community apartment projects and stock cooperatives; or
- an apartment unit or single family residence (SFR). [Bus & P C §10131.01]

An individual acting without a real estate license, either as a broker or agent, is guilty of a public offense punishable by a maximum fine of $20,000 for an individual or $60,000 for a corporation, six months in jail, or both a fine and imprisonment. [Bus & P C §10139]

Continuing education requirements

A real estate broker and real estate agent license is valid for four years from the date of issuance noted on the license certificate. [Bus & P C §§10153.6; 10153.7]

All real estate brokers and sales agents must complete at least **45 hours of continuing education (CE)** to renew a license issued by the DRE. [Bus & P C §10170.5]

The CE requirements for license renewal were legislated to help maintain and improve the level of competence of real estate brokers and agents.

Real estate agents who passed the DRE licensing examination and/or submitted a license application on or after 10/01/2007, and brokers renewing for the first time, must complete 45-hours of DRE-approved CE consisting of:

- five mandatory three-hour courses (15-hours) in the following subjects:

Violations of real estate law

Violation of a real estate law by a broker or his sales agent may result in the suspension or revocation of the license by the Real Estate Commissioner. The following are grounds for suspension or revocation of a DRE license.

Business and Professions Code §10176

The commissioner may, upon his or her own motion, and shall, upon the verified complaint in writing of any person, investigate the actions of any person engaged in the business or acting in the capacity of a real estate licensee within this state, and he or she may temporarily suspend or permanently revoke a real estate license at any time where the licensee, while a real estate licensee, in performing or attempting to perform any of the acts within the scope of this chapter has been guilty of any of the following:

(a) Making any substantial misrepresentation.

(b) Making any false promises of a character likely to influence, persuade or induce.

(c) A continued and flagrant course of misrepresentation or making of false promises through real estate agents or salespersons.

(d) Acting for more than one party in a transaction without the knowledge or consent of all parties thereto.

(e) Commingling with his or her own money or property the money or other property of others which is received and held by him or her.

(f) Claiming, demanding, or receiving a fee, compensation or commission under any exclusive agreement authorizing or employing a licensee to perform any acts set forth in Section 10131 for compensation or commission where the agreement does not contain a definite, specified date of final and complete termination.

(g) The claiming or taking by a licensee of any secret or undisclosed amount of compensation, commission or profit or the failure of a licensee to reveal to the employer of the licensee the full amount of the licensee's compensation, commission or profit under any agreement authorizing or employing the licensee to do any acts for which a license is required under this chapter for compensation or commission prior to or coincident with the signing of an agreement evidencing the meeting of the minds of the contracting parties, regardless of the form of the agreement, whether evidenced by documents in an escrow or by any other or different procedure.

(h) The use by a licensee of any provision allowing the licensee an option to purchase in an agreement authorizing or employing the licensee to sell, buy, or exchange real estate or a business opportunity for compensation or commission, except when the

licensee prior to or coincident with election to exercise the option to purchase reveals in writing to the employer the full amount of licensee's profit and obtains the written consent of the employer approving the amount of the profit.

(i) Any other conduct, whether of the same or a different character than specified in this section, which constitutes fraud or dishonest dealing.

(j) Obtaining the signature of a prospective purchaser to an agreement which provides that the prospective purchaser shall either transact the purchasing, leasing, renting or exchanging of a business opportunity property through the broker obtaining the signature, or pay a compensation to the broker if the property is purchased, leased, rented or exchanged without the broker first having obtained the written authorization of the owner of the property concerned to offer the property for sale, lease, exchange or rent.

(k) Failing to disburse funds in accordance with a commitment to make a mortgage loan that is accepted by the applicant when the real estate broker represents to the applicant that the broker is either of the following:

(1) The lender.

(2) Authorized to issue the commitment on behalf of the lender or lenders in the mortgage loan transaction.

(l) Intentionally delaying the closing of a mortgage loan for the sole purpose of increasing interest, costs, fees, or charges payable by the borrower.

(m) Generating an inaccurate opinion of the value of residential real property, requested in connection with a debt forgiveness sale, in order to do either or both of the following:

(1) Manipulate the lienholder to reject the proposed debt forgiveness sale.

(2) Acquire a financial or business advantage, including a listing agreement, that directly results from the inaccurate opinion of value, with regard to the subject property.

Business and Professions Code §10177

The commissioner may suspend or revoke the license of a real estate licensee, or may deny the issuance of a license to an applicant, who has done any of the following, or may suspend or revoke the license of a corporation, or deny the issuance of a license to a corporation, if an officer, director, or person owning or controlling 10 percent or more of the corporation's stock has done any of the following:

(a) Procured, or attempted to procure, a real estate license or license renewal, for himself or herself or a salesperson, by fraud, misrepresentation, or deceit, or by making a material misstatement of fact in an application for a real estate license, license renewal, or reinstatement.

(b) Entered a plea of guilty or nolo contendere to, or been found guilty of, or been convicted of, a felony, or a crime substantially related to the qualifications, functions, or duties of a real estate licensee, and the time for appeal has elapsed or the judgment of conviction has been affirmed on appeal, irrespective of an order granting probation following that conviction, suspending the imposition of sentence, or of a subsequent order under Section 1203.4 of the Penal Code allowing that licensee to withdraw his or her plea of guilty and to enter a plea of not guilty, or dismissing the accusation or information.

(c) Knowingly authorized, directed, connived at, or aided in the publication, advertisement, distribution, or circulation of a material false statement or representation concerning his or her designation or certification of special education, credential, trade organization membership, or business, or concerning a business opportunity or a land or subdivision, as defined in Chapter 1 (commencing with Section 11000) of Part 2, offered for sale.

(d) Willfully disregarded or violated the Real Estate Law (Part 1 (commencing with Section 10000)) or Chapter 1 (commencing with Section 11000) of Part 2 or the rules and regulations of the commissioner for the administration and enforcement of the Real Estate Law and Chapter 1 (commencing with Section 11000) of Part 2.

(e) Willfully used the term "realtor" or a trade name or insignia of membership in a real estate organization of which the licensee is not a member.

(f) Acted or conducted himself or herself in a manner that would have warranted the denial of his or her application for a real estate license, or has either had a license denied or had a license issued by another agency of this state, another state, or the federal government revoked or suspended for acts that, if done by a real estate licensee, would be grounds for the suspension or revocation of a California real estate license, if the action of denial, revocation, or suspension by the other agency or entity was taken only after giving the licensee or applicant fair notice of the charges, an opportunity for a hearing, and other due process protections comparable to the Administrative Procedure Act (Chapter 3.5 (commencing with Section 11340), Chapter 4 (commencing with Section 11370), and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code), and only upon an express finding of a violation of law by the agency or entity.

(g) Demonstrated negligence or incompetence in performing an act for which he or she is required to hold a license.

(h) As a broker licensee, failed to exercise reasonable supervision over the activities of his or her salespersons, or, as the officer designated by a corporate broker licensee, failed to exercise reasonable supervision and control of the activities of the corporation for which a real estate license is required.

(i) Has used his or her employment by a governmental agency in a capacity giving access to records, other than public records, in a manner that violates the confidential nature of the records.

(j) Engaged in any other conduct, whether of the same or a different character than specified in this section, which constitutes fraud or dishonest dealing.

(k) Violated any of the terms, conditions, restrictions, and limitations contained in an order granting a restricted license.

(l)(1) Solicited or induced the sale, lease, or listing for sale or lease of residential property on the ground, wholly or in part, of loss of value, increase in crime, or decline of the quality of the schools due to the present or prospective entry into the neighborhood of a person or persons having a characteristic listed in subdivision (a) or (d) of Section 12955 of the Government Code, as those characteristics are defined in Sections 12926 and 12926.1, subdivision (m) and paragraph (1) of subdivision (p) of Section 12955, and Section 12955.2 of the Government Code.

(2) Notwithstanding paragraph (1), with respect to familial status, paragraph (1) shall not be construed to apply to housing for older persons, as defined in Section 12955.9 of the Government Code. With respect to familial status, nothing in paragraph (1) shall be construed to affect Sections 51.2, 51.3, 51.4, 51.10, 51.11, and 799.5 of the Civil Code, relating to housing for senior citizens. Subdivision (d) of Section 51 and Section 1360 of the Civil Code and subdivisions (n), (o), and (p) of Section 12955 of the Government Code shall apply to paragraph (1).

(m) Violated the Franchise Investment Law (Division 5 (commencing with Section 31000) of Title 4 of the Corporations Code) or regulations of the Commissioner of Corporations pertaining thereto.

(n) Violated the Corporate Securities Law of 1968 (Division 1 (commencing with Section 25000) of Title 4 of the Corporations Code) or the regulations of the Commissioner of Corporations pertaining thereto.

(o) Failed to disclose to the buyer of real property, in a transaction in which the licensee is an agent for the buyer, the nature and extent of a licensee's direct or indirect ownership interest in that real property. The direct or indirect ownership interest in the property by a person related to the licensee by blood or marriage, by an entity in which the licensee has an ownership interest, or by any other person with whom the licensee has a special relationship shall be disclosed to the buyer.

(p) Violated Article 6 (commencing with Section 10237).

(q) Violated or failed to comply with Chapter 2 (commencing with Section 2920) of Title 14 of Part 4 of Division 3 of the Civil Code, related to mortgages.

If a real estate broker that is a corporation has not done any of the foregoing acts, either directly or through its employees, agents, officers, directors, or persons owning or controlling 10 percent or more of the corporation's stock, the commissioner may not deny the issuance of a real estate license to, or suspend or revoke the real estate license of, the corporation, provided that any offending officer, director, or stockholder, who has done any of the foregoing acts individually and not on behalf of the corporation, has been completely disassociated from any affiliation or ownership in the corporation.

  - agency;
  - fair housing;
  - trust funds;
  - ethics; and
  - risk management;
- a minimum of 18-hours of *consumer protection* courses; and
- the remaining clock hours needed to complete the 45-hours may be categorized as either **consumer protection** or *consumer service*.

The renewal requirement for brokers and agents on every subsequent four-year renewals is similar. However, the licensee may take either the five mandatory three-hour courses or one eight-hour survey course covering the five mandatory subjects.

Courses covering the following real estate-based topics are considered **consumer protection** courses:

- real estate financing;
- land use regulation and control;
- consumer disclosures;
- agency relationships;

- capital formation for real estate development;
- fair practices in real estate;
- appraisal and property valuation technique;
- property management;
- energy conservation;
- environmental regulation;
- probate;
- mineral, oil and gas conveyancing;
- government programs such as redevelopment;
- business opportunities; and
- taxation of real estate transactions. [Bus & P C §10170.5(a)(6)]

Consumer service courses cover topics designed to help licensees achieve a higher level of competence in sales, organizational and management skills. Examples of consumer service courses include:

- how to market property;
- how to hold an open house;
- how to motivate sellers; and
- how to obtain a listing.

A licensee is exempt from CE requirements under a so-called *senility statute* if, on the actual renewal date of the real estate license, the licensee:

- is at least 70 years of age; and
- has been a real estate licensee in California for at least 30 consecutive years. [Bus & P C §10170.8]

The corporate license

Acts for which a real estate license is required may be performed as services rendered in the name of a corporation if an officer of the corporation who holds a real estate license qualifies the corporation for a license to be issued by the DRE. [DRE Reg §2740]

The officer qualifying the corporation for a corporate broker license is called the *designated officer (DO)*. The corporation holds its brokerage license through the DO.

The DO is responsible for the supervision and control of the activities of officers and employees of the corporation. This includes supervision of the activities of agents and brokers employed to act as agents for the corporate broker. Failure of the DO to supervise may result in the suspension or revocation of the DO's real estate license.

The individual broker, when acting as the DO, acts on behalf of the corporation in the capacity of a corporate officer only. The individual who is the DO may also become an employee of the corporation and act as an agent of the corporation rendering services to the corporation's clients.

The DO is liable to the corporation for any failure to supervise agents. However, the DO is not liable to corporate clients for breaching his duty to supervise agents – this supervision is a duty owed to his employer, the corporation and the DRE who entrusted him as a designated officer.

Partnerships

The DRE does not issue partnership or LLC licenses.

A partnership among licensed brokers may perform brokerage activities when every partner through whom the partnership acts is a licensed real estate broker. [Bus & P C §10137.1]

A real estate broker who is a member of a partnership operating as a real estate brokerage business under written agreement with other brokers may conduct business from a branch office of the partnership without acquiring a branch office license in his name. [DRE Reg. §2728]

To do so, at least one broker who is a member of the partnership must have a current branch office license at the location. [DRE Reg. §2728]

Editor's note – Accountants and attorneys, but not real estate brokers, may render professional services through a limited liability partnership (LLP). A partner in a registered LLP is not liable in any way, including indemnity and contribution for any debts, obligations or liabilities of the partnership or another partner. Brokers are limited to the use of a corporation.

Fictitious business name

A licensee may use a *fictitious business name* in any activity for which a real estate license is required, if the license is issued under the fictitious name. [DRE Reg. §2731(a)]

A **fictitious business name** license will only be granted to a broker who has complied with the filing requirements for a fictitious business name, also known as a *d.b.a. ("doing business as...").* [DRE Reg. §2731(b)]

The DRE will refuse to issue a license under a fictitious business name when:

- the name is misleading or would constitute false advertisement;
- implies a partnership or corporation exists when one does not;
- includes the name of a real estate agent;
- violates California's Business and Professions Code on fictitious business name requirements; or
- is the name formerly used by a licensee whose license has been revoked. [DRE Reg. §2731(c)]

Prepaid rental listing service

Apartment locator services which do not include the negotiation of rentals require a *Prepaid Rental Listing Service (PRLS)* license or a real estate broker license from the DRE for individuals who:

- gather data on numerous properties;
- compile, sort and publish data as a list; and
- sell a rental list to prospective tenants for an advance or contemporaneous fee.

The rental listing service may be a one-time sale of a list, or a short-term subscription with continuing updates of available rentals.

Mineral, oil and gas

A real estate broker and agent may solicit and negotiate for the purchase, lease or exchange of mineral, oil and gas property. The licensee may also arrange or negotiate and service loans on mineral, oil and gas property. [Bus & P C §10500]

Finally, the licensee may rent mineral, oil and gas property and collect the rents or royalties from the mineral, oil and gas property. [Bus & P C §10500]

Child support obligations

The DRE cannot issue or renew a real estate license if the applicant is on a list of persons not in compliance with **child support orders** provided by the State Department of Social Services. [Calif. Family Code §17520]

However, the DRE may issue a **150-day temporary license** to an otherwise qualified applicant who is on the list of persons neglecting child support. Only one 150-day license will be issued, and a four-year license cannot be issued until a release is obtained from the district attorney's office. [Fam C §17520]

The State Department of Social Services also provides the DRE with a supplemental list of real estate licensees who are delinquent in child support payments for more than **four months**. If the licensee does not renew his license with the DRE within six months of the DRE's receipt of the supplemental list, the license will be subject to suspension.

The DRE has the authority to suspend the license of any licensee placed on the supplemental four-month delinquency list. However, before a license can be suspended, the DRE must give the licensee notice that the license will be suspended 150 days after the notice is served, unless the licensee receives a release from the district attorney.

Also, any real estate licensee whose name appears on the certified list or supplemental list provided by the State Department of Social Services for noncompliance with an order for child support is liable to the DRE for a special handling fee of $95 for each time his or her name is on the list. [Fam C §17520; DRE Reg. §2716.5]

The DRE commissioner will not issue a license or reinstate a suspended license until the $95 fee is paid. [DRE Reg. §2716.5]

Nationwide Mortgage Licensing System and Registry (NMLS) website:
www.mortgage.nationwidelicensingsystem.org

Business opportunities

A *business opportunity* is the sale or lease of the operations and goodwill of an existing business enterprise or opportunity.

Common types of **business opportunities** include:

- liquor stores;
- gas stations; and
- restaurants.

The arranging of a sale or purchase of a business opportunity is governed by the DRE. To receive a fee for the sale of a business opportunity, it is necessary to hold a real estate license, unless the person receiving the fee is licensed as a **securities broker** or **dealer** by California or the United States.

The sale of a business opportunity consists of two transactions:

- the sale of the business, including inventory, trade fixtures and goodwill; and
- the sale of the real property itself, whether a fee or leasehold interest, including the building and land.

The documents used in the sale of a business include a *bill of sale* and *UCC-1 Financing Statement* for the personal property, and a *deed* (or assignment of the leasehold and a trust deed) for the transfer of the real property.

Bulk Sales

On the sale of a business opportunity, the inventory of the business is transferred to the buyer by a **bill of sale**. The transfer of more than one-half the inventory of a business' materials or goods to a person other than the business' customers is called a *bulk sale*. A **bulk sale** must comply with the Uniform Commercial Code (UCC) since it is the transfer of personal property. [Calif. Commercial Code §6102]

The buyer of the inventory must give public notice of the transfer 12 days before the transfer takes place to perfect their interest in the acquisition of the inventory on closing. [Com C §6105]

Mobilehome sales

Mobilehomes have a unique legal status, being either real estate or personal property.

A **mobilehome**, also called a *manufactured home*, is a structure:

- at least eight feet in width, 40 feet in length or more than 320 square feet when transported in one or more sections;
- built on a permanent chassis;
- designed to be used as a dwelling with or without a permanent foundation. [Calif. Health and Safety Code §18007]

A mobilehome that meets the requirements for attachment to a permanent foundation is no longer considered personal property but **real estate**, since it is a permanent fixture or an improvement to real estate. [Health & S C §§18039.1; 18551]

The broker handling the sale of a mobilehome that is considered real estate conducts himself as any broker would on the sale of any real estate.

The rules for buying, selling, registering and encumbering mobilehomes that are not considered real property differ from the rules for real estate sales.

The government agency responsible for the registration of mobilehomes is the *California Department of Housing and Community Development (HCD)*. Mobilehomes are registered with the HCD, unless the mobilehome is considered real estate. [Health & S C §§18206; 18000 et seq.]

A licensed real estate broker may act as an agent in the sale of any mobilehome that has already been registered with the HCD, even though it is still considered personal property. If the mobilehome is new and has not been registered with the HCD, a real estate broker cannot act as an agent in its sale. [Bus & P C §10131.6]

When a new mobilehome is first purchased without the paid assistance of a real estate broker, it is registered on a form provided by the HCD, called the *original registration* of the mobilehome.

At the time of the **original registration** of the mobilehome, the HCD creates a permanent title record for the mobilehome.

The permanent title record shows:

- the owner of the mobilehome, called the *registered owner* [Health & S C §18400.1];
- any senior lienholder, called the *legal owner* since the lienholder retains the certificate of title as evidence of his security interest in the mobilehome [Health & S C §18551(B)]; and
- any junior lienholders in order of priority, based on the sequence in which the junior liens were filed with the HCD. [Health & S C §18005.3]

The registered owner is issued a *registration card*, the legal owner receives the *certificate of title*, and the junior lienholders receive copies of the registration card, which documents their priority.

Real Estate Recovery Fund

The *Real Estate Recovery Fund* is available to individuals who have obtained a final-court judgment against a real estate licensee and are unable to recover the judgment from the licensee for losses caused while acting as an agent.

The judgment must be based on:

- fraud, misrepresentation or deceit;
- conversion of trust funds; or
- criminal restitution. [Bus & P C §10471]

Recovery from the fund is limited to $20,000 for each transaction and $100,000 for any one licensee for causes of action which occurred on or after January 1, 1980. For causes of action which occurred on or after January 1, 2009, the threshold has been increased to $50,000 for one transaction and $250,000 for any one licensee. [Bus & P C §10474]

A licensee's license will be suspended and will not be reinstated until the licensee repays any amounts paid from the **Real Estate Recovery Fund** to satisfy a judgment against him. [Bus & P C §10475]

Attorney fees are not recoverable from the Recovery Fund. [Bus & P C §10471]

Mortgage loan brokerage

If you are a mortgage loan broker who will make, arrange or receive fees for the origination of loans controlled by the Real Estate Settlement and Procedures Act (RESPA), you must become **endorsed** by the DRE.

Editor's note – RESPA controlled loans include only consumer-purpose equity or purchase-assist loans, or the refinancing of one of these loans, when secured by one-to-four unit residential property. RESPA does not include investment, agricultural or business loans, regardless of the type of real estate used as security. Also excluded are consumer loans secured by any real estate other than one-to-four unit residential property.

To become DRE-endorsed as a *mortgage loan originator (MLO)*, you must:

1. register with the *Nationwide Mortgage Licensing System and Registry (NMLS)*; and
2. pass both a state and a federal mortgage loan brokerage exam.

The Federal Exam contains **100** multiple choice questions (90 of which are scored), to be completed in a **150** minute time limit. These questions are broken down as follows:

- 35% Federal mortgage-related laws;
- 25% General mortgage knowledge;
- 25% Mortgage loan origination activities; and
- 15% Ethics.

The State Exam contains **60** multiple choice questions (50 of which are scored), to be completed in a **150** minute time limit. These questions are broken down as follows:

- 5% California Department of Corporations (DOC) and California DRE;
- 10% California laws and regulations (laws related to land, homeownership, and lending);
- 25% California license law and regulations (licensee requirements and qualifications);
- 50% Compliance (required and forbidden conduct for mortgage loan originators); and
- 10% Disciplinary action for noncompliance.

The NMLS is an offshoot of the larger regulatory scheme known as the *Secure and Fair Enforcement (SAFE) Mortgage Licensing Act*.

When a licensee needs an MLO endorsement

Business and Professions Code §10166.02

An **MLO** who makes, arranges or services consumer-purpose equity or purchase-assist loans, or the refinancing of these loans, when secured by one-to-four unit residential property must notify the DRE of his mortgage loan origination activities **thirty days** following the commencement of his mortgage loan origination activity.

An MLO may not act as a mortgage loan originator without first:

- having a real estate license; and
- obtaining an endorsement to that license from the DRE qualifying the licensee as a mortgage loan originator.

License endorsements will expire yearly on December 31, unless renewed.

The DRE may work with the NMLS, or its affiliates, to keep records and process any fees related to real estate mortgage loan originator endorsements.

Any broker who does not notify the DRE of his mortgage loan origination activities and obtain a license endorsement permitting him to act as a mortgage loan originator will be fined $50 for each day he acts as a loan originator until the DRE is notified, and $50 per day until license endorsement is received. If more than 30 days, pass, the fee will rise to a penalty of $100 per day, up to a total of $10,000. The DRE may revoke a broker's license if he refuses to pay this penalty.

Background information from applicants

Business and Professions Code §10166.04

When applying for an endorsement or license to act as a mortgage loan originator, an applicant must provide:

- fingerprints, to be used in a background check; and
- personal history and experience, on a form to be provided by the NMLS.

The DRE may ask the NMLS to obtain a state criminal history background check on all applicants for endorsement. If it does so, and the NMLS submits the fingerprints and related information electronically to the *Department of Justice (DOJ)* to obtain information about the applicant's criminal history, then the DOJ will provide an electronic response to both the NMLS and the DRE.

The Department of Justice will charge a reasonable fee for this service.

Education requirements for MLO endorsement

Business and Professions Code §10166.06

All applicants for license endorsement from the DRE must complete a minimum of 20 hours of education, including:

- three hours of **federal law and regulations**;
- three hours of **ethics**, including instruction on fraud, consumer protection and fair lending issues; and
- two hours of training related to **lending standards** for nontraditional mortgages.

Before receiving a license endorsement, applicants must pass a written exam approved by the NMLS. This exam must test the applicant's knowledge of:

- ethics;
- all laws regulating mortgage loan origination; and

- all laws regulating fraud, consumer protection and fair lending issues.

The exam must be administered by a test administrator approved by the NMLS. The administrator may provide the test at the applicant's home or place of employment.

To pass the exam, the applicant must get a score of at least 75%. If the applicant fails, he may retake the exam up to two times, with a minimum wait period of 30 days between each attempt. If he fails the exam three times, the applicant must wait a minimum of six months before making another attempt.

If a mortgage loan originator does not maintain his endorsement for a minimum of five years, or does not register with the state of California as a loan originator, then he must retake the written exam.

Continuing education for MLOs

Business and Professions Code §§10166.09 and 10166.10

To keep their endorsement, MLOs must continue to meet minimum licensing/endorsement standards, pay the yearly renewal fee and complete a minimum of eight hours of continuing education annually, including:

- three hours of federal law and regulations;
- two hours of ethics (including instruction on fraud, consumer protection and fair lending issues); and
- two hours on lending standards for nontraditional mortgages.

All continuing education courses must be approved by the DRE and the NMLS. The DRE may substitute any of the above courses with qualified agent and broker license renewal courses, so long as the substituted courses are substantially equivalent to those listed above.

Continuing education may be offered in a classroom, online or in any other format approved by the DRE and the NMLS.

Credit for continuing education courses may only be granted for the year in which the course is taken.

MLOs may not take the same course more than once every two years to meet the continuing education requirement.

Approved courses remain valid if completed outside of the state of California.

If a loan originator's license endorsement expires, or is suspended or revoked, the originator must complete the applicable continuing education requirements for the last year that the license was held before the endorsement can be reinstated.

Chapter 6 Finders: a nonlicensee referral service

This chapter addresses a broker's or his agent's use of finders to provide them with leads to sellers, buyers or borrowers under California and federal law.

For a further discussion of this topic, see Chapter 20 of Real Estate Practice.

Chapter 6 Outline

Agency relationships in real estate transactions
Soliciting to place or refer a match
RESPA limits authority to split fees
Business development and RESPA
Fee sharing by a broker under RESPA
Entitlement to a fee under RESPA
Referral fees to other fiduciaries prohibited
The finder's fee bargain

Chapter 6 Terms

Bona fide employee	*Referral*
Business model	*Settlement service provider*
Licensee	*Unlicensed finder*
Real Estate Settlement Procedures Act	

Agency relationships in real estate transactions

Three classes of **real estate agents** have been established in California:

- **licensed** brokers;
- **licensed** sales agents; and
- **unlicensed** finders.

Licensed brokers and **sales agents** owe *fiduciary duties* to the principals they represent. **Fiduciary duties** require licensees to perform on behalf of their client with the utmost care and diligence.

An *unlicensed finder* has no such fiduciary duty. A finder's function as an "agent" is limited to soliciting, identifying, and referring potential real estate clients or participants to brokers, agents, or principals in exchange for the promise of a fee.

A finder working for a principal is distinguished from a licensed broker working for a principal. Limitations are placed on the **conduct of a finder**.

A finder lacks legal authority to participate in any aspect of property information dissemination or other transactional negotiations. [Calif. Business and Professions Code §§10130 et seq.]

Although not licensed by the California Department of Real Estate (DRE) or admitted as members of a real estate trade association, finders are authorized by California statute to solicit prospective buyers, sellers, borrowers, lenders, tenants, or landlords for *referral* to real estate licensees or principals. Thus, they **provide leads** about individuals who may become participants in real estate transactions.

Soliciting to place or refer a match

A finder providing referral services in California for a fee may:

- find and **introduce parties**;
- **solicit parties** for referral to others [**Tyrone** v. **Kelley** (1973) 9 C3d 1]; and
- be **employed** by principals or brokers.

A finder may not:

- take part in any negotiations [Bus & P C §10131(a)];
- discuss the price;
- discuss the property; or
- discuss the terms or conditions of the transaction. [**Spielberg** v. **Granz** (1960) 185 CA2d 283]

A finder who crosses into any aspect of negotiation which leads to the creation of a real estate transaction needs a real estate license as he is both **soliciting and negotiating**. Unless licensed, an individual who enters into negotiations (supplying property or sales information) cannot collect a fee for services rendered — even if he calls it a finder's fee. Also, he is subject to a penalty of up to $20,000 and/or a six-month jail term for engaging in brokerage activities without a license. [Bus & P C §§10137, 10139]

In addition, a broker who permits a finder or anyone else in his employ (or his agents' employ) to perform any type of "licensed" work beyond solicitation for a referral, may have his license suspended or revoked. [Bus & P C §§10131, 10137]

RESPA limits authority to split fees

The Real Estate Settlement Procedures Act (RESPA) prohibits brokers, with two major exceptions, from giving or accepting a referral fee if the broker or his agent is acting as a *trans-*

action agent in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related loan. [24 United States Code §2607(a); 24 Code of Federal Regulations §3500.14(b)]

The two **RESPA exceptions** are:

- **referral fees** paid to or received from other brokers [24 CFR §3500.14(g)(1)(v)]; and
- fees paid by the broker to the broker-employed licensed sales agents or *unlicensed finders* within the broker's office. [24 CFR §3500.14(g)(1)(vii)]

A broker and his agents are not involved in a RESPA transaction when negotiating the sale, lease, or encumbrance of any of the following types of properties:

- apartment buildings with five or more units;
- commercial buildings;
- agricultural properties;
- business opportunities;
- vacant land (other than those involving one-to-four unit residential construction loans);
- properties containing 25 or more acres;
- leases and rental agreements;
- all-cash transactions; and
- seller carryback transactions where no federally-related loan is originated. [12 USC §2606(a)(1); 24 CFR §3500.5(b)(1)]

Business development and RESPA

A broker and his agents need to develop methods for **generating business**. If not, their *business model* will not produce sufficient numbers of clientele to provide enough earnings to keep them from being driven out of the real estate brokerage profession.

Many methods for finding and soliciting clientele exist. The source of clients most often discussed, and cherished, is the **referral**. In fact, agents not employed by media/franchise brokers are said to live by referrals alone.

Also, brokers cooperate among themselves, as in agent-to-agent referrals between different segments of the brokerage community, such as the referral of a homebuyer by a property manager to an MLS sales agent and vice versa with a prospective tenant.

Brokers and agents in single family residence (SFR) sales rarely develop a client base of homebuyers sufficiently large enough to sustain a decent standard of living from sales fees

generated by transactions handled on behalf of these homebuyer clients. Thus, a **business model** for finding and locating clients on a regular basis must include sources other than clients personally located, i.e., found by the broker.

Many methods exist to generate new clients. Advertising through printed and electronic/digital media to solicit clients is fundamental and universally understood and expected by all. Media advertising is a **general blast** at members of the public in an effort to locate those few among them who, at that moment, need the services of a real estate agent.

On the other hand, finding and locating a client becomes a more focused and arduous task when a broker's business model expands beyond exclusive use of media, which develops name recognition for the broker/agents, into the time consuming task of **personally soliciting** clients.

In a personal solicitation effort designed as an additional method for generating clientele, the agent places himself and those he induces to act on his (specifically, his broker's) behalf, directly between the prospective client and the employing broker, e.g., when:

- the employing broker "refers" clients directly to his agent;
- an agent takes "floor time" to solicit new clients who call in response to media advertising and the "brand name" the broker has established;
- an agent canvasses a neighborhood or section of the community in a classic on-going *farming operation* to find and solicit new clientele (for his broker); or,
- an agent extends his reach to potential buyers and sellers of SFRs by inducing both licensed and unlicensed individuals to be "team members" who locate and solicit clientele for the agent (again, read that as for the broker), all being activities which comply with both RESPA and Department of Real Estate (DRE) regulations.

It is the employment of unlicensed *locators* of buyers and sellers to extend the reach of the agent to develop business which will bring his earnings to a level sufficient to sustain the standard of living the agent seeks. This is permissible. State and federal regulations addressing the **relationship** between the finder/locator and the broker/agent, and between the public and the finders/locators acting on behalf of the broker/agent, are straightforward and compliance is relatively easy.

All employees of a broker must be hired under **written contracts** of employment. Licensed agents are hired, administrative staff is hired, and finders are hired by brokers. Written contracts are entered into to delineate the responsibilities each has undertaken and to limit their conduct to that permitted by regulations for their different licensed or unlicensed status.

These employments, the **finder** included, are not casual relationships which the broker/agent develops over time with friends, neighbors, past clientele, or social contacts, a word-of-mouth network of "viral adverts" generating referrals for which no fee is paid. Employed individuals **generate business** for the broker/agent, the **finder** being limited by the nature of his employment to locating and soliciting new clientele for the broker/agent.

Fee sharing by a broker under RESPA

RESPA, like a title insurance policy, initially sets out a blanket rule as the starting point for arriving at the final conditions. RESPA's initial statement is that no **referral fee** can be paid or received by a settlement service **provider** (broker/escrow/lender) who will be rendering transactional services in exchange for compensation in a RESPA sale (mortgage financing on a one-to-four unit residential sale).

Likewise, a title insurance policy's initial statement proclaims no encumbrance of any type exists on the title being insured. The policy provisions then proceed to list exclusions, exceptions, and conditions which nearly neuter the initial general statement.

Here too, as with all initial statements and generalities, RESPA provides several exceptions allowing fee sharing. These exceptions permit the broker to conduct orderly **business development** which does not violate the RESPA principle of avoiding double dipping (referrals among providers) or surcharges.

RESPA's goal is to prohibit activity which **artificially drives up** the cost buyers and sellers pay for services needed to close a sale such as occurs with duplicate fees charged for services implicitly covered by the provider's basic fee.

The two **RESPA exceptions** referenced above go to the heart of sourcing new clientele and sharing fees:

- referral fees paid to or received from other brokers, a *horizontal disbursement* from one broker to another, other than by loan brokers or lenders who are or will be involved in a resulting RESPA transaction [24 CFR §3500.14(g)(1)(v)]; and

- fees paid by the broker to the broker-employed licensed sales agents or **unlicensed finders**, a *vertical disbursement* within the broker's office, not paid to providers or third parties connected or to be connected to a resulting RESPA transaction. [24 CFR §3500.14(g)(1)(vii)]

While both of these exceptions to RESPA permit payment of fees under federal law, DRE regulations under California law **limit the conduct** of these individuals when actually rendering services permitted by RESPA.

While the RESPA exceptions allow *fee-splitting* activity, the DRE regulations require the **fee splitting** to be limited exclusively to:

- payments between brokers (who then may split the fee with their agents); or

- payments between a broker and the agents he employs, licensed or unlicensed.

While RESPA allows agents and finders who are employed by a broker to receive fees for **generating business**, the DRE regulations (and statutory/case law) set forth the *limits of conduct* each type of employee of the broker may undertake with the clientele.

To **satisfy RESPA**, the employment of a finder must be under an agreement where the employee-finder is obligated to bring to the broker's attention **every prospect** located of the sort the broker is looking for. The employee-finder's sole purpose is to generate business for his broker and does not have the freedom, by contract, to refer a prospect to just any broker. [24 CFR §§3500.2(b), 3500 Appendix B, examples 11 and 12; **Zalk** v. **General Exploration Co.** (1980) 105 CA3d 786; see **first tuesday** Form 115]

Three classes of finders exist under RESPA:

- **friends or past customers** who pass on tips to brokers and/or sales agents;
- **individuals** who sell "lead lists" to brokers; and
- **bona fide employees** of brokers who generate business for their employing broker, classified as *financial services representatives (FSRs)*. [24 CFR §3500 Appendix B, example 12]

Entitlement to a fee under RESPA

Finders are also entitled to a fee for referrals under RESPA, dependent upon the type of finder they are and whether RESPA controls.

A friend or past customer type of unlicensed finder who is not under contract and therefore not employed by a broker would not be entitled to a finder's fee if the broker to whom a new client was referred provided settlement services on a RESPA-controlled transaction. If RESPA did not control, this type of finder would be entitled to a fee under California law.

A *bona fide employee*, such as a FSR, of a broker is not barred from collecting a fee or salary from his employer-broker since employed individuals are exceptions to RESPA.

A person who sells lead lists are also able to legally collect a fee under both RESPA and non-RESPA transactions. Lead lists are considered "goods" and are perfectly legal in California, as well as under the RESPA exception for goods actually furnished. [24 CFR §3500.14(g)(1)(iv); see DRE Real Estate Bulletin, Spring 2006]

Referral fees to other fiduciaries prohibited

Anyone can be a paid finder, unless barred by professional regulations or code-of-ethics or conflict-of-interest policies controlling an individual's conduct.

For instance, a licensed agent registered with the DRE as an employee of a broker cannot be a finder. The agent is employed to solicit clients on behalf of his broker, not others. In turn, only his broker can receive a fee generated by the agent's real estate licensed activities. On the employing broker's receipt of a fee, the fee is split with the agent under their written employment agreement. [Bus & P C §10132; Department of Real Estate Regulations §2726]

Certified public accountants (CPAs) are barred by regulation from being paid as finders and receiving a fee for the referral of their clients to others. [16 Calif. Code of Regulations §56]

A finder who advertises to locate leads he will place or refer to a broker or principal must not hold himself out as also rendering services which require a broker's license. [Bus & P C §10139]

The finder's fee bargain

Generally, a *finder's fee* is a lump sum amount or a percentage of the fee received by the broker on a transaction which is closed due to the finder's referral. Only sound economics controls the amount of the fee a broker, agent or principal should pay a finder for a lead. Also, no limit is placed on the volume of referral business conducted by a finder.

For instance, a broker can compensate his finder with:

- a salary;
- a percentage fee; or
- a lump sum basis per closing. [Zalk, *supra*]

Also, while brokers may, finders may not collect advance fees from principals. *Advance-fee operators*, masking themselves as finders for principals, sometimes collect fees "up front," a prohibited activity for an unlicensed individual. [Bus & P C §10131.2]

Entitlement to a fee under California law

A finder is entitled to a fee as an unlicensed individual if he solicits, locates, places, introduces, or delivers up names of prospective clients to a broker or principal. [Tyrone, *supra*]

A finder's fee agreement entered into between a **finder and a principal** regarding the finder's referral services must be **evidenced in a writing** signed by the principal who employed the finder. If not, the finder cannot enforce his fee agreement with the principal. [Calif. Civil Code §1624(a)(4)]

However, the principal's **use and benefit** of a finder's referral under an oral finder's fee agreement, such as closing a sale with an individual referred by the finder, will substitute for a written agreement. [**Tenzer** v. **Superscope, Inc.** (1985) 39 C3d 18]

Conversely, oral fee agreements between a **broker** (or his agents) **and a finder** are enforceable. No written agreement is required between a broker (or his agents) and a finder. However, a writing memorializes the agreement as documentation against memories to the contrary, and in conformance with DRE regulations. [See **first tuesday** Form 115]

Fair Housing

Chapter 7 — Civil rights and fair housing laws

This chapter outlines the federal and California anti-discrimination laws and how the laws affect the management of residential and nonresidential rental property.

For a further discussion of this topic, see Chapter 1 and 2 of the "Fair Housing" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 7 Outline

Chapter 7 Terms

Blockbusting	*Federal Fair Housing Act (FFHA)*
Familial status	*Steering*
Federal Civil Rights Act	*Unruh Civil Rights Act*

Property rights cannot be based on status

All citizens of the United States have the right to rent real estate, regardless of race, under the Civil Rights Act. [42 United States Code §1982]

Further, **all persons** within the United States, legally or illegally, are given the same rights to make and enforce contracts (rental and lease agreements), sue, be sued, enjoy the full benefits of the law and be subject to the same punishments, penalties, taxes and licenses, regardless of race. [42 USC §1981]

The *Federal Civil Rights Act* applies to race discrimination on the rental of all types of real estate, both residential and nonresidential.

Thus, the right of an individual to lease real estate is protected by giving all persons the right to make and **enforce contracts**, regardless of race. **Racially motivated activities** in any real estate leasing transaction are prohibited.

Federal protection against racial discrimination given under the **Civil Rights Act** applies to discrimination in all activities between persons, and is much broader than the protection given under the **Federal Fair Housing Act**, which is limited to dwellings.

Anti-discrimination in residential property

Unlawful discrimination in the rental or advertisement of dwellings for rent is based on status and prohibited under the *Federal Fair Housing Act (FFHA)*. [42 USC §§3601 et seq.]

A **dwelling includes** any building or structure that is occupied, or designed to be occupied, as a residence by one or more families composed of one or more people. Also included is any vacant land offered for lease for residential dwelling purposes, such as property that would hold a mobilehome unit. [42 USC §3602(b)]

Discriminatory actions of a landlord or property manager **prohibited** under FFHA are any actions a landlord or property manager may take in the negotiations or handling of a residential rental, based on a person's:

- race or color;
- national origin;
- religion;
- sex;
- familial status; or
- handicap. [42 USC §3602]

Familial status refers to the group of occupants of a residence comprised of one or more individuals who are under the age of 18 years and:

- a parent or person having legal custody of those under 18; or
- a person having written permission of the parent or legal custodian of those under 18 as the designee of the parent or custodian. [42 USC §3602(k)]

Handicapped persons refer to individuals who have:

- a physical or mental impairment which substantially limits the person's life activities; or
- a record of, or are regarded as having, a physical or mental impairment. [42 USC §3602(h)]

The term **handicap** does not include the current illegal use of a controlled substance. However, alcoholics and individuals who are considered "recovering or recovered addicts" are protected as handicapped. [**United States** v. **Southern Management Corporation** (4th Cir. 1992) 955 F2d 914]

Qualifying and processing tenants

A landlord or property manager is prohibited under FFHA **from unlawfully discriminating** during negotiations and handling of the rental of a dwelling. [42 USC §3604(a)]

Thus, a landlord or property manager may not:

- **refuse to rent** a dwelling or to negotiate the rental of a dwelling for unlawful discriminatory reasons;
- impose **different rental charges** on a dwelling for unlawful discriminatory reasons;
- use **different qualification criteria** or different procedures for processing applications in the rental of a dwelling to unlawfully discriminate; or
- **evict tenants** or the tenant's guests for unlawful discriminatory reasons. [24 Code of Federal Regulations §100.60(b)]

Different criteria for tenant qualification or processing of rental applications include a landlord or property manager using different credit standards and tenant screening approval procedures in the negotiations or handling of the rental of a dwelling. [24 CFR §100.60(b)(4)]

Different terms, different privileges

A landlord or property manager may not unlawfully discriminate against a person by setting different terms, conditions or privileges for his rental of a dwelling, or by providing substandard services and facilities for the dwellings. [42 USC §3604(b)]

For example, a prospective tenant who is a member of a protected class (race, ethnicity, etc.) responds to an ad concerning the rental of a residence in a new housing development.

The property manager shows the prospective tenant the residence. The prospect informs the broker he is interested in renting the property.

The prospective tenant is then informed he cannot rent this particular unit. Due to the prospect's minority status, the property manager and the owner believe it would become more difficult to rent the remaining units in the development with this tenant occupying a unit.

The property manager offers to show the tenant a unit in another area of the development.

Here, the property manager has discriminated against the prospective tenant. The property manager improperly refused to rent the unit to the tenant due to the tenant's status as a member of a protected class of people, such as race, religion, handicap, etc. [**United States** v. **Pelzer Realty Company, Inc.** (5th Cir. 1973) 484 F2d 438]

Prohibited **selective reduction** of tenant privileges, conditions, services and facilities offered protected individuals in the rental of a dwelling includes:

- providing for different terms in a lease, such as the rental charge, security deposit and the term of the lease;
- delaying or failing to perform maintenance;
- limiting use of privileges, services or facilities to different classes of individuals; or
- refusing or failing to provide services or facilities due to a person's refusal to provide sexual favors. [24 CFR §100.65(b)]

Further, the landlord or property manager may not discriminate based on a person's status by representing that a dwelling is not available for rent in order to **steer the individual** to a particular Section 8 project or neighborhood, when the dwelling is available.

Steering involves the restriction of a person seeking to rent a dwelling in a community, neighborhood or development, in a manner that perpetuates segregated housing patterns. [42 USC §3604(d); 24 CFR §100.70]

Discrimination in advertisement

A broker making a notice, statement or advertisement when handling the rental of a dwelling unit is barred from using any wording that **indicates a discriminatory preference or limitation** against individuals of protected classes of people. [42 USC §3604(c)]

The prohibition against unlawful discriminatory advertisements applies to all oral and written statements.

Notices and statements includes any applications, flyers, brochures, deeds, signs, banners, posters and billboards used in the rental of a dwelling.

Blockbusting for exploitation

A residential landlord or property manager may not induce or attempt to induce a person to rent a dwelling to ensure the entry of certain classes of people into the neighborhood can be used to exploit discrimination, called *blockbusting*. [42 USC §3604(e)]

Further, the actual receipt of an profit is not necessary to establish discrimination provided profit was a motive for the landlord's or broker's **blockbusting** activity. [24 CFR §100.85(b)]

Examples of blockbusting activities by a broker or his agent include:

- encouraging an **owner-occupant to offer** a dwelling for rent by insinuating that a neighborhood is undergoing or is about to undergo a change in the race, color, religion, sex, handicap, familial status or national origin of its residents; or
- discouraging an **owner-occupant from renting** a dwelling by claiming the entry of persons of a particular race, color, religion, sex, familial status, handicap or national origin will result in undesirable consequences for the neighborhood or community, such as an increase in criminal activity or a decline in schools and other facilities. [24 CFR §100.85(c)]

Aiding in discriminatory activities

Landlords and their agents may not coerce, intimidate, threaten or interfere with any person from a protected class of people in their occupancy or enjoyment of a dwelling. [42 USC §3617]

For example, a mobilehome park is allowed to operate as a **de facto** "adults-only" park under local rent control ordinances. However, the park owner never legally declares the park exempt from the FFHA as a **de jure** senior citizens housing development.

Later, local rent control ordinances are amended, allowing the park management to rent vacated spaces to new residents without rent amount restrictions. The park owner then decides to open the park by renting newly vacated units to families with children.

Senior tenants currently renting mobilehome spaces in the park file an application with the city seeking a rent reduction, claiming families with children cause a reduction in available services. The city awards the tenants the reduction in rent they sought.

The park owner claims the city violated the FFHA since the rent reductions for existing tenants was a prohibited discriminatory interference since the action inhibited the owner's decision to rent to families with children.

The city claims it did not violate the FFHA since the park met the requirements of a senior citizen housing project, and was therefore exempt from the FFHA.

However, the city did interfere with the owner's rental of the mobilehomes to families with children in violation of the FFHA. The older tenants are not entitled to a reduction in rent based on the occupancy of spaces by families.

The owner's rental of mobilehome spaces to families with children cannot be the basis for reducing rent paid by tenants who do not have children. Further, only an owner, not a governmental agency, can claim the park is exempt from the FFHA under the senior housing exemption. [**United States** v. **City of Hayward** (9th Cir. 1994) 36 F3d 832]

Exemptions for some discrimination

FFHA-prohibited discrimination in the rental of a residential dwelling **does not** apply to a single-family house rented by a landlord who:

- does not own more than three single-family homes;
- does not use a real estate licensee to negotiate or handle the tenant; and
- does not use a publication, posting or mailing for any discriminatory advertisement. [42 USC §3603(b)(1)]

Thus, the FFHA prohibitions apply to all notices, statements and advertisement in the rental of a dwelling by anyone, be they an owner or a broker, who are in the business of renting dwellings. [42 USC §3603]

A person is in the **business of renting dwellings** if the person:

- has participated within the past 12 months **as a principal** in three or more transactions involving the rental of any dwelling or interest in a dwelling;
- has participated within the past 12 months **as an agent**, negotiating two or more transactions involving the rental of any dwelling or interest in a dwelling, excluding the agent's personal residence; or
- is **the owner** of a dwelling structure intended to be occupied by five or more families (larger than a fourplex). [42 USC §3603(c)]

If a broker is the agent for either the landlord or the tenant in a residential rental transaction, the anti- discrimination rules of the FFHA apply.

However, attorneys, escrow agents, title companies and professionals other than brokers who are employed by a landlord to complete a transaction do not bring the transaction under the FFHA, unless they **participate in negotiations** with the tenant. [42 USC §3603(b)(1)(B)]

Also exempt from discrimination prohibition rules in the rental of a dwelling is a one-to-four unit residential property in which one of the units is **occupied by the owner**. [42 USC §3603(b)(2)]

Consider an owner of three SFRs, who maintains two of his properties as rental income-producing properties. The owner holds a Department of Real Estate (DRE) issued real estate license, and is actively involved in rendering real estate related services to members of the public in expectation of a fee. Is the owner exempt from FFHA?

Yes, on one troublesome "appearance" condition! An owner of no more than three SFRs who fits the FFHA exemption requirements is exempt as long as the owner is a real estate licensee who does not hold himself out or give the appearance of acting as an agent in the management of his SFR properties.

Thus, the licensed owner cannot use his public real estate office where he renders real estate licensed services to solicit tenants for his SFR rentals and remain exempt from FFHA.

The owner who distributes his real estate office phone numbers, cards or rental signs linking the soliciting of tenants for his SFR rentals with his real estate office or licensee status implies to prospective tenants that the owner might owe the tenant licensee duties. It is this implication that dissolves the exemption for active licensees since soliciting business with a public image is a vital component of earning a living acting as a real estate licensee.

Religious organizations who limit the rental or occupancy of dwellings to individuals of the same religion are also exempt, provided the dwelling is owned for **noncommercial reasons**. No religious exemption exists if the religion is restricted to persons of a particular race, color or national origin. [42 USC §3607(a)]

Also exempt are **private clubs** that are not open to the public and provide their members with residential dwelling space for noncommercial purposes may limit rental or occupancy of the dwellings to members.

Finally, **housing qualified for older citizens** which excludes children is not considered unlawful discrimination against tenants with children based on familial status. However, the housing must first qualify as housing for the elderly. [42 USC §3607(b)]

Failure to comply with the FFHA

An **aggrieved person** under FFHA is any individual who claims he has been injured by an unlawful discriminatory housing practice or believes he will be injured by a prohibited discriminatory housing practice. [42 USC §3602(i)]

The aggrieved individual may file a complaint with the Secretary of Housing and Urban Development (HUD), alleging a discriminatory housing practice. The complaint must be filed within one year of the alleged discriminatory housing practice. [42 USC §3610(a)]

The Secretary will **attempt to resolve** the dispute by having the parties enter into an agreement after informal negotiations. [42 USC §3610(b)]

However, a judicial action may be required to resolve the issue of discrimination if the Secretary concludes judicial involvement is necessary. The dispute will then be resolved by an administrative law judge.

Any party to the complaint may elect to have the claims decided in a civil action before a court of law. [42 USC §3612(a)]

When a real estate broker subjected to a judicial action is ruled to have committed discriminatory housing practices, the Secretary is to notify the DRE and recommend disciplinary action. [42 USC §3612(g)(5)]

When a court determines discriminatory housing practices have taken place, actual and punitive amounts of money awards may be granted and an order issued preventing the landlord or broker from engaging in any future discriminatory housing practice. [42 USC §3613(c)(1)]

Further, if the Attorney General commences a civil action against a person for prohibited discriminatory housing practices, the court may award:

- relief preventing further discriminatory housing practices such as an injunction or restraining order;
- money losses; and
- civil penalties of no more than $50,000 for the first violation and no more than $100,000 for any subsequent violation. [42 USC §3614(d)]

The State Civil Rights Act

California's *Unruh Civil Rights Act*, an anti- discrimination law, specifically prohibits discrimination by a **business establishment** based on numerous status classifications, including: a person's sex, race, color, religion, ancestry, national origin, disability or medical condition. [Calif. Civil Code §§51; 51.2; 51.3]

However, age is a legitimate discrimination as long as the restriction is in a project that qualifies as a senior citizen housing development.

The Unruh Civil Rights Act applies to anyone in the **business of providing housing**. Brokers, developers, apartment owners, condominium owners and single-family residential owners are considered to be in the business of providing housing.

As business establishments, landlords may not boycott, blacklist, refuse to lease or rent because of the race, creed, religion, color, national origin, sex, disability or medical condition of a person, or that person's business partners, members, stockholders, directors, officers, managers, agents, employees, business associates or customers.

Further, a prospective tenant may not be blacklisted or boycotted for prohibited discriminatory reasons. [CC §51.5]

Full and equal access guaranteed

A **blind prospective tenant** has a guide dog and seeks to rent an available unit in a multi- unit residential dwelling structure.

The landlord refuses to rent a unit to the blind tenant, claiming the guide dog violates the building's pet restriction in the covenants, conditions and restrictions.

The blind tenant claims the landlord is discriminating against him under California law due to his **disability** since the landlord denied him housing on account of the guide dog.

A landlord may not refuse to rent residential property to a blind tenant because of the tenant's guide dog. Landlords are also prohibited from discriminating against tenants with dogs specially trained to assist deaf and other disabled persons. [CC §54.1(b)(6)]

Fair housing for disabled persons

Disabled persons are protected from discrimination when renting or leasing California residential real estate. A disabled person anyone who:

- has a physical or mental impairment which significantly limits major life activities;
- has a record of a disability; or
- is regarded as being disabled. [CC §54(b)]

People with disabilities are entitled to full and equal access to housing accommodations offered for rent. [CC §54.1(b)(1)]

The only exception is the rental of no more than one room in a single-family residence. [CC §54.1(b)(2)]

The examples of the blind tenant and his seeing-eye dog illustrate how a landlord might attempt to avoid anti-discrimination laws. While the landlord claims to justify his behavior based on his equal application of a single pet restriction rule to pet owners (a non-protected class of people), the refusal to rent to a disabled tenant based on his reliance on a trained dog to conduct life activity is an unlawful discrimination.

Now consider a disabled tenant dependent on his spouse for financial support. The disabled tenant and his spouse seek to rent an apartment and will both sign the lease agreement. The spouse's income meets the landlord's minimum requirement to qualify to pay the rent.

However, the landlord refuses to rent an apartment to the couple, claiming the disabled tenant does not also meet minimum income requirements.

Here, the landlord may not deny housing to the disabled tenant based on the tenant being financially dependent on his spouse. The **combined incomes** of the tenant and his spouse meet the landlord's minimum income requirements for the payment of the rent amount.

The landlord's refusal to rent an apartment to the disabled tenant based on the tenant's dependency on his spouse's income is unlawful discrimination. If one tenant qualifies to rent a unit, both tenants are qualified. [CC §54.1(b)(7)]

Accommodating the disabled

A landlord is not required to structurally modify existing residential rental property to meet the special needs of disabled tenants. [CC §54.1(b)(4)]

Although he is not required to modify the structure for a disabled tenant, the landlord must allow the tenant to make reasonable modifications himself or pay the landlord to do so. The landlord may require the tenant to restore the property to its original condition when the tenancy is terminated. [Calif. Government Code §12927]

Anti-discrimination laws require new residential properties consisting of four or more units per building to be **built to allow** access by disabled persons. Required improvements include

kitchens and bathrooms designed to allow access to disabled tenants in addition to wheelchair ramps.

Failure to provide the disabled with access to a newly constructed residential property with four or more units is considered unlawful discrimination. [Gov C §12955.1]

Remedies to stop discrimination

An individual's primary remedy for discrimination based on his physical disability is to seek an injunction to stop the discriminatory activity. The injunction may be sought by the disabled person being discriminated against, or by the city attorney, district attorney or Attorney General. [CC §§55; 55.1]

Property owners who unlawfully discriminate against disabled persons are further liable for the disabled person's money losses. In addition to actual money losses, treble that dollar amount may be awarded as punitive damages, along with attorney fees. The minimum award of money damages for discrimination against a disabled person is $1,000. [CC §54.3]

**Discriminatory practices,
exemptions and remedies**

An ethnic or religious minority tenant seeks to rent an apartment. The landlord informs the prospective tenant he cannot rent the apartment until he completes a credit check. The landlord also declines to accept a deposit from the tenant.

Later the same day, a nonminority tenant seeks to rent the same apartment. The landlord agrees to rent the apartment to the nonminority tenant without first requiring a credit check, and immediately accepts the tenant's check for a deposit on the apartment. The minority tenant is informed the apartment has been rented to another person.

The minority tenant files a complaint against the landlord, claiming the landlord discriminated against him based on his ethnicity or religion by refusing to rent him an apartment. The landlord claims no discrimination occurred since he was entitled to require a credit check of prospective tenants.

However, requiring a credit check of minority tenants, but not nonminority tenants, an unlawful discriminatory practice which allows the minority tenant to recover his money losses. [**Stearns** v. **Fair Employment Practice Commission** (1971) 6 C3d 205]

Prohibited discrimination in housing

California law prohibits discrimination in the sale or rental of housing accommodations based on race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status, source of income or disability. This list of protected persons is more extensive than all others.

Discriminatory activities and conduct include:

- making a written or oral **inquiry into** the race, sex, disability, etc. of any person seeking to rent housing;
- ads or notices for rental of housing which state or infer **preferences or limitations** based on any of the prohibited discrimination factors;
- a broker **refusing to represent** an individual in a real estate transaction based on any prohibited factor; and
- any other practice that denies housing to a member of a protected class. [Gov C §12955]

The denial of housing based on the landlord or broker's **perception** that a prospective tenant, or any associates of the prospective tenant, has any of the protected characteristics is absolutely prohibited. [Gov C §12955(m)]

Income standards for tenants

Standards of conduct that a broker applies **equally to all individuals** which do not discriminate against a **protected group of individuals** are considered reasonable, and permitted to be used.

To qualify a tenant for occupancy based on his creditworthiness, a landlord or property manager may establish income ratios or standards to determine a tenant's ability to pay the rent. The higher the standard or ratio of income to rent, the less the risk of loss of rent borne by the landlord. The lower the standard, the greater the risk of loss of rent. Once set, the standard must be **applied to all equally**.

However, when renting to two or more individuals who desire to live in the same unit, whether related or unrelated, married or not, the **income of all tenants** must be considered as the total income used by the landlord to determine their collective eligibility to qualify to pay the rent amount sought.

Separately, each prospective tenant may be unable to qualify by meeting the income standard. However, if **aggregating the income** of all who intend to occupy the unit and enter into the rental or lease agreement results in total income sufficient under the ratio or standard applied to qualify a tenant or tenants for occupancy, the tenants qualify. [Gov C §12955(n)]

Also, under rent subsidy programs, such as Section 8 housing arrangements, the landlord or property manager must consider the tenant's income when assessing whether the tenant qualifies to pay their portion of the rent that is not subsidized. [Gov C §12955(o)]

The **source of income** for each occupant also includes any income claimed to be the tenant's that is lawfully received by the tenant and verifiable, whether it is directly received by the tenant or received by a representative of the tenant. [Gov C §12955(p)]

Familial status for the children

Familial status in anti-discrimination laws refers to children under the age of 18 living with a parent or guardian. [Gov C §12955.2]

Rental policies excluding children under the age of 18 are classified as unlawful discrimination, unless the property qualifies as senior citizen housing. [Gov C §12955.9]

Religious organizations may give preference to other members of the same religious group when providing residential property for noncommercial purposes unless membership is restricted on account of race, color or national origin. [Gov C §12955.4]

Marital status of co-applicants for housing

Consider a landlord who refuses to rent an apartment to an unmarried couple based on his religious beliefs.

The couple files a complaint with the Fair Employment and Housing commission, claiming the landlord violated fair housing laws that prohibit discrimination based on marital status.

The landlord claims he is exempt since renting to an unmarried couple violates his religious beliefs regarding the cohabitation of unmarried couples.

However, the landlord's refusal to rent to unmarried couples violates the fair housing laws since the landlord's religious beliefs do not also require him to participate in the business of renting property.

Thus, the fair housing laws prohibiting discrimination based on marital beliefs do not interfere with the practice of the landlord's religion, since he can go into a business that does not violate his religious convictions. [**Smith** v. **Fair Employment and Housing Commission** (1996) 12 C4th 1143]

Guidelines for broker conduct

The Department of Real Estate (DRE) has enacted regulations prohibiting discriminatory practices by real estate brokers. A broker or agent engaging in discriminatory business practices may be disciplined by the DRE. [Department of Real Estate Regulations §2780]

Prohibited practices include any situation in which a broker, while acting as an agent, discriminates against anyone based on race, color, sex, religion, ancestry, disability, marital status or national origin. Examples of discriminatory practices include:

- refusing to negotiate for the rental of real estate;
- refusing to show property or provide information, or steering clients away from specific properties;
- refusing to accept a rental listing;
- publishing or distributing advertisements that indicate a discriminatory preference;
- any discrimination in the course of providing property management services;
- agreeing with a client to discriminate when leasing the client's property, such as agreeing not to show the property to members of particular minority groups;

- attempting to discourage the rental of real estate based on representations of the race, sex, disability, etc. of other inhabitants in an area; and
- encouraging or permitting employees to engage in discriminatory practices.

Broker's duty to manage employees

A broker has a **duty to advise** his agents and employees of anti-discrimination rules, including DRE regulations, the Unruh Civil Rights Act, the California Fair Employment and Housing Act and the Federal Fair Housing Act. [DRE Reg. §2725(f)]

The broker is not only responsible for his own conduct, but he must also ensure his employees follow anti-discrimination regulations when acting as agents on his behalf.

Disclosure of HIV/AIDS

A property manager locates a rental for a prospective tenant. The prior occupant of the property was afflicted with AIDS. Neither the property manager nor the landlord disclose the prior occupant's AIDS affliction, whether or not asked by the prospective tenant.

The tenant rents the property and later discovers the prior occupant was afflicted with AIDS while residing on the property. The tenant claims the property manager had a duty to disclose the prior occupant had AIDS.

However, the tenant has no claim against the property manager for the property manager's failure to disclose any prior occupant was infected with the HIV virus or afflicted with AIDS. No duty exists to disclose the prior tenant's affliction. [CC §1710.2(a)]

Further, California public policy prohibits a broker from responding to a tenant's inquiry for disclosure of a prior occupant's affliction with AIDS. [CC §1710.2(d)]

Also, individuals afflicted with the HIV virus are considered handicapped and are protected by the Federal Fair Housing Act. [24 CFR §100.201]

Disclosing death from AIDS

Unless the tenant makes a **direct inquiry**, the landlord's or property manager's affirmative duty to voluntarily disclose material facts to the tenant in a lease transaction does not extend to the **death** of a prior occupant occurring **more than three years before** the lease of a property.

Consider a tenant who asks the property manager if any AIDS-related deaths occurred on the property. On direct inquiry, the property manager must disclose his knowledge of the facts concerning a death on the real estate. [CC §1710.2(d)]

If the property manager is aware an AIDS-related death occurred on the property, he has a duty on direct inquiry from the tenant to disclose:

- the prior occupant's death; and
- the death was AIDS-related.

If the property manager has no knowledge of any AIDS-related deaths occurring on the property, he must disclose:

- his lack of knowledge; and
- whether or not he intends to undertake an investigation to determine if an AIDS-related death occurred on the property.

However, consider a property manager who is aware a death, from any cause including AIDS, occurred on the property **within three years** of the commencement of a tenant's lease agreement. The tenant has not inquired if any deaths have occurred on the property.

Here, the property manager will need to determine if the death on the property is a **material fact**, one which might affect the tenant's decision to lease and occupy the property.

The property manager should disclose **any death** occurring on the property within three years if he believes the fact might affect the tenant's decision to lease. On inquiry from the tenant, the property manager must disclose his knowledge of any death, including AIDS-related deaths, which occurred on the property within the last three years.

Chapter 8 California Fair Employment and Housing Act

This chapter establishes California's enforcement of racial and familial discrimination rules in housing accommodations.

For a further discussion of this topic, see Chapter 6 of the "Fair Housing" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 8 Outline

Prohibited factors
Enforcement is complaint driven

Chapter 8 Terms

Denial of housing	*Making an inquiry*
Familial status	*Refusal based on a prohibited factor*
Indicate a preference	*Prohibited discrimination*

Prohibited factors

California law prohibits discrimination in the sale or rental of housing accommodations based on the distinguishing factors of race, color, religion, sex, marital status, national origin, ancestry, familial status or disability.

Discriminatory practices include:

- **making an inquiry**, written or oral, into the race, sex, disability, etc. of any person seeking to rent or purchase housing;
- ads or notices for the sale or the rental of housing which **indicate a preference** or limitation based on any of the prohibited factors;
- **use of prohibited discrimination** when providing or arranging real estate loans and financing;
- **refusal based on a prohibited factor** by a broker to represent an individual in a real estate transaction; and
- any other practice that **denies housing** to a member of a protected class. [Calif. Government Code §12955]

Familial status in anti-discrimination law refers to a situation in which children under the age of 18 live with a parent or guardian. [Gov C §12955.2]

Until familial status was added to the anti-discrimination laws in 1992, it was legal to exclude minors under the age of 18 from housing accommodations. However, policies excluding children under the age of 18 are now classified as unlawful discrimination, unless the property qualifies as senior citizen housing. [Gov C §12955.9]

As with senior citizen housing, an exemption also exists for religious groups. Religious organizations may *give preference* to members of the same religious group when providing residential property for noncommercial purposes as long as membership to that religion is not restricted on account of race, color or national origin. [Gov C §12955.4]

However, a landlord may not use religious beliefs to shield discriminatory conduct.

Enforcement is complaint driven

The Department of Fair Employment and Housing (Department) and the Fair Employment and Housing Commission (Commission) are the agencies of the California state government which enforce anti-discrimination law. [Gov C §§12901, 12903, 12930, 12935]

Any person who feels they have been discriminated against may bring a complaint to the Department of Fair Employment and Housing. The Department investigates the complaint and seeks to resolve the situation through discussions with the person against whom the complaint is made. [Gov C §12980]

If the Department believes a discriminatory practice has occurred and is unable to reach a resolution through informal discussions, the Department then submits an *accusation* to the Fair Employment and Housing Commission. [Gov C §12981]

The Commission holds a hearing on the accusation. If the Commission finds unlawful discrimination has occurred, it may order a remedy for the person complaining of discrimination, such as ordering the person accused of discrimination to sell or rent property to the person bringing the complaint. The Commission may also impose punitive damages of up to $10,000 on a first offense. [Gov C §12987]

Chapter 9 — DRE regulation of discrimination

This chapter sets out discriminatory practices which are prohibited activities of licensees while acting as agents.

For a further discussion of this topic, see Chapter 7 of the "Fair Housing" section of *<u>Agency, Fair Housing, Trust Funds, Ethics and Risk Management</u>*.

Chapter 9 Outline

Guidelines for licensee conduct
Blockbusting
Broker's duty to employees

Chapter 9 Terms

Blockbusting	*Implicit discrimination*
Discriminatory practices	*Panic selling*

Guidelines for licensee conduct

Several regulations prohibiting discriminatory practices by real estate brokers and agents have been established by the Department of Real Estate (DRE). A broker or agent found guilty of engaging in discriminatory business practices may be disciplined by the DRE. [Department of Real Estate Regulation §2780]

Prohibited discriminatory practices include any situation in which a broker or agent discriminates against anyone based on race, color, sex, religion, ancestry, disability, marital status or national origin. Discriminatory practices include:

- refusing to negotiate for the purchase, sale or rental of real estate;
- refusing to show property or provide information, or steering clients away from specific properties;
- discriminating in the terms and conditions of a real estate sale, such as charging minority buyers higher prices;
- refusing to accept a rental or sales listing or an application for financing;
- publishing or distributing advertisements which indicate a discriminatory preference;

- limiting access to Multiple Listing Services (MLS);
- any discrimination in the course of providing property management services;
- agreeing with a client to discriminate when selling or leasing the client's property, such as agreeing not to show the property to members of particular minority groups;
- attempting to discourage the purchase or rental of real estate based on representations of the race, sex, disability, etc. of other inhabitants in an area; and
- encouraging or permitting employees to engage in discriminatory practices. [DRE Reg§§2780 et seq.]

Blockbusting

Regulations also prohibit the old practice of blockbusting, also known as *panic selling*. [DRE Reg. §2781]

Panic selling is an attempt to influence sales or rentals of real estate through representations about a change in the ethnic makeup of a neighborhood and the consequences of the economic impact brought about by the change. [See Chapter 1]

Of course, such blatantly discriminatory practices are not as common now as they once were. The focus now is on *implicit discrimination* — practices which are not openly discriminatory, but which have discriminatory effects.

Therefore, brokers and their agents must be careful in their dealings, in order to avoid actions with discriminatory effects.

Broker's duty to employees

A broker has a duty to advise his agents and employees of anti- discrimination rules, including DRE regulations, the *Unruh Civil Rights Act*, the *Fair Employment and Housing Act*, and federal fair housing law. [DRE Reg. §2725(f)]

Thus, the broker is not only responsible for his own conduct, but must also take steps to ensure his employees follow anti-discrimination regulations when acting as agents on his behalf.

Chapter 10 — Equal Credit Opportunity Act

This chapter clarifies the federal rules which require those who make or arrange loans to eliminate discriminatory practices.

For a further discussion of this topic, see Chapter 8 of the "Fair Housing" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 10 Outline

Fairness in mortgage lending
Discrimination by age

Chapter 10 Terms

Equal Credit Opportunity Act	*Loan applicant's age*
Immigration status	*Public assistance program income*

Fairness in mortgage lending

The *Equal Credit Opportunity Act* prohibits discrimination in lending based on race, color, religion, national origin, sex, marital status or age (provided an individual is of legal age).

The anti-discrimination rules apply to institutional lenders, loan brokers, and others who regularly **make or arrange loans**. [15 United States Code §1691a(e)]

Income from a **public assistance program**, such as **welfare or social security**, must be considered by lenders and loan brokers as part of an applicant's income. To deny a loan based on an applicant's receipt of income from a public assistance program is unlawful discrimination. [15 USC §1691(a)(2)]

Discriminatory practices take many forms, including:

- treating minority loan applicants less favorably than non- minority applicants, or placing additional burdens on minority applicants;
- requiring a spouse's signature on a loan application when an applicant qualifies for a loan individually [**Anderson** v. **United Finance Company** (1982) 666 F2d 1274];
- discouraging loan applicants based on their race, color, sex, etc. [12 Code of Federal Regulations §202.5(b)]; and
- making inquiries into the marital status of loan applicants. [12 CFR §202.5(d)]

Also, the lender may not make any inquiries into whether a loan applicant's income is derived from **alimony or child support**, or whether the applicant intends to bear children. [12 CFR §202.5(d)]

Discrimination by age

Some exceptions to the anti-discrimination rules do exist.

For example, a lender may lawfully consider a loan applicant's age and whether the applicant receives income from a public assistance program when determining the applicant's creditworthiness. [15 USC §1691(b)(2)]

Editor's note — Allowing lenders to consider an applicant's age or receipt of income from a public assistance program as an exception in determining the applicant's creditworthiness effectively removes these two factors from the anti-discrimination protection previously discussed.

While a lender may not refuse to accept applications or impose different loan terms based on an applicant's age or receipt of public assistance income, the lender can lawfully deny a loan based on these factors simply by stating the applicant is not creditworthy.

Also, lenders may consider an applicant's **immigration status** when considering loan applications to determine whether the applicant is a permanent resident of the United States. [12 CFR §202.6(b)(7)]

After the lender's receipt of a loan application, the lender has 30 days to notify the applicant as to whether the loan is approved or denied. If the lender denies the loan application, the lender must deliver a statement to the applicant listing the specific reasons for the denial. [15 USC §1691(d)]

Alternatively, if the lender does not give the applicant a statement of the specific reasons for the denial, the lender must deliver a notice to the applicant that states the applicant has the right, upon request, to obtain a statement which lists the reasons for denial.

In addition to the *Equal Credit Opportunity Act*, California law controls credit reporting agencies. California grants consumers the right to inspect their files at any credit reporting agency. [Calif. Civil Code §1785.10]

Also, like the federal law, California law requires lenders using credit reporting services to provide loan applicants a statement of reasons if their loan application is denied. [CC §1785.20]

Penalties for discrimination in lending include actual money losses sustained by a person who has been discriminated against and punitive money awards of up to $10,000, plus attorney fees. [15 USC §1691(e)]

Chapter 11 — The Housing Financial Discrimination Act of 1977

This chapter illustrates a creditworthy individual's entitlement to a loan secured by a fairly appraised home.

For a further discussion of this topic, see Chapter 9 of the "Fair Housing" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 11 Outline

California's fair lending laws
Increased availability of home loans
Notice of loan applicant's rights
Administrative remedies on a complaint

Chapter 11 Terms

Discriminatory preference
Community demographics
Redlining

California's fair lending laws

To achieve a healthy state economy, all residential housing placed on the real estate market for sale must be available to any homebuyer who is creditworthy and qualifies for purchase-assist financing. [Calif. Health and Safety Code §35801(b)]

Also, an efficient real estate market requires the value of housing to not be susceptible to fluctuations caused by lenders who arbitrarily deny equity financing to qualified homeowners.

Thus, state law prohibits discriminatory lending practices. The goal of anti-discrimination law in home financing is to:

- increase the amount of housing available to creditworthy buyers; and
- increase lending in communities where lenders have made conventional home loans unavailable. [Health & S C §35802]

Increased availability of home loans

Lenders must make financing available to all qualified creditworthy loan applicants attempting to acquire loans to:

- buy, build, repair, improve or refinance an existing loan on a one-to-four unit, owner-occupied residence; or
- improve one-to-four unit residences which are not owner- occupied. [Health & S C §35805(d)]

Lenders violate public policy when they indicate a **discriminatory preference** by denying or approving financing to creditworthy home loan applicants based on the applicant's:

- race;
- color;
- religion;
- sex;
- marital status;
- national origin; or
- ancestry. [Health & S C §35811]

In a community which is composed mainly of residents of a certain race, color, religion or other minority status protected by law, a lender cannot:

- refuse to fund a home loan to a creditworthy buyer based on the **demographics of that community**; or
- appraise real estate in that community at a lower value than comparable real estate in communities predominantly composed of non-minority residents. [Health & S C §§35810, 35812]

Failing to provide financing in certain communities, called *redlining*, is specifically targeted for correction by the law since the failure to lend adversely affects the health, welfare and safety of California residents. [Health & S C §35801(e)(4)]

Lenders who deny loan applications, based on the characteristics of the community where the real estate offered as security is located, discourage homeownership in the community. Thus, redlining leads to a decline in the quality and quantity of housing in areas where financing is generally unavailable. [Health & S C §35801]

However, a lender can consider neighborhood conditions when making a loan. When doing so, the lender must demonstrate a denial based on neighborhood conditions is necessary to avoid an unsafe and unsound loan as a matter of good business practice. [Health & S C §35810(a)]

For example, a lender is not precluded from considering the fair market value of real estate intended to secure a home loan. A property appraisal, however, cannot be based in any part on the demographic makeup of the area where the real estate is located. Also, if the property's topography, structure or location is unsafe or unhealthy for a prospective occupant, the lender is not required to provide purchase-assist financing. [Health & S C §35813]

Notice of loan applicant's rights

Lenders are required to post in a conspicuous public location at their place of business a written notice in no less than 10-point type informing applicants for loans to be secured by an owner- occupied, one-to-four unit residential property of:

- their right to file a lending discrimination claim; and
- the name and address of the Secretary of the California Business, Transportation and Housing Agency (Housing). [Health & S C §35830]

Lenders subject to this posting requirement include **state regulated** banks, thrifts, public agencies or other institutions which make, arrange or buy loans funded to buy, build, repair, improve or refinance one-to-four unit, owner-occupied housing. [Health & S C §35805]

A home loan applicant who believes he has been unfairly discriminated against by a state lending institution must exhaust the Housing Agency's administrative remedies before suing the lender for money losses. However, federally regulated banks and thrifts are not subject to state regulation and discipline. [**Conference of Federal Savings and Loans Associations** v. **Stein** (1979) 604 F2d 1256]

Administrative remedies on a complaint

A loan applicant may file a discrimination claim with the California Secretary of Business, Transportation and Housing Agency against a state regulated lender if the applicant believes his loan application was denied due to:

- his race, color, religion, sex, marital status, national origin or ancestry; or
- trends, conditions or characteristics of the community where the real estate that is intended to secure the loan is located. [Health & S C §§35800 et seq.]

Once the claim is received, the Secretary will attempt to work with the lender to end any unlawful discriminatory lending practices. [Health & S C §35821]

If, within 30 days of receiving the complaint, the Secretary determines the lender has engaged in an unlawful discriminatory practice, the Secretary will serve the lender with his written decision and an order requiring the lender to end the unlawful discriminatory practice. [Health & S C §35822]

The order will also require the lender to pay damages in an amount no greater than $1,000, unless it is still feasible for the lender to review the loan application under nondiscriminatory terms and provide the denied financing. [Health & S C §§35822(a), 35822(b)]

Chapter 12 Home Mortgage Disclosure Act

This chapter describes the prevention of lender discrimination under federal law.

For a further discussion of this topic, see Chapter 10 of the "Fair Housing" section of <u>*Agency, Fair Housing, Trust Funds, Ethics and Risk Management*</u>*.*

Chapter 12 Outline

Lenders release home loan data
Federal disclosure requirements
California state regulated lenders
Monitoring federally regulated lenders

Chapter 12 Terms

Disclosure statement	*Lending discrimination*
Home Mortgage Disclosure Act	*Redlining practices*

Lenders release home loan data

The federal *Home Mortgage Disclosure Act (HMDA)* seeks to prevent *lending discrimination* and unlawful *redlining practices* on residential loans or home improvement loans by requiring lenders to disclose home loan origination information to the public. [Department of Housing and Urban Development Mortgagee Letter 94-22]

State and federally regulated banks and persons engaged in the business of making home loans for profit are required by the HMDA to compile home loan origination data for submission to their respective supervisory agencies. [12 United States Code §§2802, 2803; Calif. Health and Safety Code §35816]

Completed loan applications and loan originations to finance the purchase, construction, improvement of the loan applicant's home or to refinance an existing home loan are considered home loan originations.

Federal disclosure requirements

For lenders with total assets of more than $28 million and for-profit mortgage lenders with total assets of more than $10 million, the lender is required to compile data and make it available to the public. The data will include:

- the type and purpose of the loan;
- the owner-occupancy status of the real estate securing the loan;

- the amount of the loan;
- the action taken by the lender on the application;
- the sex, race and national origin of the loan applicant; and
- the income of the loan applicant. [12 Code of Federal Regulations §203.4(a)]

The data is then grouped according to census tracts to determine the lender's activity with the tract. [12 USC §2803(j)(2)(C)]

However, lenders are exempt from HMDA disclosure requirements if:

- the lender does not have a branch office in a metropolitan statistical area (MSA); or
- the lender's assets on the preceding December 31 totalled less than $28 million. [12 CFR §203.3(a)(1)]

For-profit mortgage lenders are exempt from HMDA disclosure requirements if on the preceding December 31:

- the mortgage lender did not have a branch office in a MSA; or
- the mortgage lender's assets totalled less than $10 million and the lender originated less than 100 home purchase loans in the preceding year. [12 CFR §203.3(a)(2)]

Regardless of exemptions, all lenders approved by the Department of Housing and Urban Development (HUD) must report to HUD and disclose the census tract information on all Federal Housing Administration (FHA) loans they originate. [HUD Mortgagee Letter 94-22]

California state regulated lenders

Lenders who regularly originate residential loans and do not report to a federal or state regulatory agency are required to compile data on the number and dollar amount of loan originations — actual originations and completed loan applications — for each fiscal year. [21 Calif. Code of Regulations §7118(a)]

Examples of state regulated lenders who fall into this category include insurers, mortgage bankers, investment bankers and credit unions that do not make federally related mortgage loans.

The data is first categorized by geographical area, then by census tract. For each census tract, loan originations are grouped according to:

- FHA, FmHA and Veterans Administration (VA) loan originations on owner-occupied, one-to-four unit dwellings;

- conventional purchase-assist loan originations on owner- occupied, one-to-four unit dwellings;

- home improvement loan originations on owner-occupied, one-to-four unit dwellings; and

- home improvement loan originations on occupied, one-to-four unit dwellings not occupied by the owner. [21 CCR §7118(b)(2)]

California regulated lenders exempt from loan origination disclosures are:

- lenders whose originations of purchase-assist loans totalled less than 10% of the lender's loan volume during the current reporting year; and

- licensed real estate brokers who negotiate or arrange purchase-assist and home improvement loans. [21 CCR §7121]

Monitoring federally regulated lenders

Federally regulated lenders are subject to investigation and penalties by federal authorities. [12 USC §2803(h)]

While disclosure of home loan statistics helps to identify lending patterns, loan statistics alone are not sufficient to determine whether a lender is unlawfully practicing redlining or discrimination.

The loan statistic disclosures may be relevant when considered in conjunction with other evidence, such as the credit histories of denied loan applicants and debt ratios. [HUD Mortgagee Letter 94-22]

Chapter 13 HUD advertising guidelines for sales and rentals

This chapter sets forth the advertising guidelines for the sale and rental of residential property established by the Department of Housing and Urban Development (HUD).

For a further discussion of this topic, see Chapter 11 of the "Fair Housing" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 13 Outline

Avoiding discrimination in advertising
Marketing real estate for sale or rent
The HUD fair housing poster
Failure to follow HUD guidelines

Chapter 13 Terms

Discriminatory preference	*Fair housing poster*
Dwelling	*Federal Fair Housing Act (FFHA)*
Exclusion	

Avoiding discrimination in advertising

The printing or publishing of an advertisement for the sale or rental of buildings designed for residential occupancy, called *dwellings*, that indicates a *discriminatory preference*, is a violation of the *Federal Fair Housing Act (FFHA)*. [42 United States Code §3604(c); see Chapter 1]

The discriminatory preference rule applies to all brokers, developers and landlords in the business of selling or renting dwellings. [42 USC §§3603, 3604]

Real estate advertising guidelines are issued by the *Department of Housing and Urban Development (HUD)*. The guidelines are the criteria by which the **HUD** Assistant Secretary for Fair Housing and Equal Opportunity determines whether a broker has practiced or will practice discriminatory preferences in their advertising and availability of real estate services.

However, HUD guidelines also help the broker, developer, and landlord avoid signalling preferences or limitations for any group of persons when marketing real estate for sale or rent.

Marketing real estate for sale or rent

The selective use of words, phrases, symbols, visual aids and media in the advertising of real estate may indicate a discriminatory preference held by the advertiser. When published, the preference could lead to a claim of discriminatory housing practices.

Words in a broker's real estate advertisement that indicate a particular race, color, sex, handicap, familial status or national origin are considered likely violations of the FFHA.

A broker should be aware of and refuse to use phrases that indicate a preference, even if requested by a seller or landlord, such as:

- white private home;
- Jewish home;
- black home; or
- adult building.

Catch words which may convey discriminatory preferences and are often used in a discriminatory context should also be avoided. Preferences are often voiced in colloquialisms and words such as *restricted, exclusive, private, integrated* or *membership approval*.

Indicating a preference by age is an *exclusion* from unlawful discrimination when marketing qualified 55-or-over residences or communities.

Selective use of *media* or *human models* in an advertising campaign can also lead to discrimination against minority groups.

A look at HUD

The *United States Department of Housing and Urban Development (HUD)* was founded in 1965 to develop and administer uniform housing policies and development projects.

HUD is responsible for the oversight of:

- the Federal Housing Administration (FHA);
- regulation of Fannie Mae and Freddie Mac (collectively referred to as *Frannie*);
- manufactured housing;
- housing for individuals with disabilities; and
- multifamily housing programs.

HUD's stated mission is to:

> *Create strong, sustainable, inclusive communities and quality affordable homes for all. HUD is working to strengthen the housing market to bolster the economy and protect consumers; meet the need for quality affordable rental homes: utilize housing as a platform for improving quality of life; build inclusive and sustainable communities free from discrimination; and transform the way HUD does business*.

U.S. Department of Housing and Development's (HUD's) website:
www.HUD.gov

The HUD fair housing poster

HUD issues guidelines that require real estate brokers marketing dwellings to display a *fair housing poster*. [24 CFR §§110.1, 110.10]

The fair housing poster is available at any HUD office. [24 CFR §110.20]

The broker marketing dwellings for sale or rent is to display the fair housing poster:

- in the broker's place of business; and
- at any dwelling offered for sale, other than SFRs. [24 CFR §110.10(a)]

Thus, a broker holding an open house at a SFR listed for resale is not required to display the fair housing poster at the residence.

However, if the dwellings marketed are part of a residential development, the fair housing poster must also be displayed by the developer during construction of the development.

Later, the poster is to be displayed in the model dwellings whether or not the dwellings are sold employing a broker's services. [24 CFR §§110.10(a)(2)(ii), 110.10(a)(3)]

The fair housing posters must be placed where they can be easily seen by any persons seeking to:

- engage the services of the broker to list or locate a dwelling; or
- purchase a dwelling in a residential development. [24 CFR §110.15]

Failure to follow HUD guidelines

Even though it is required, a broker will not be subject to any penalties for failing to display the fair housing poster. However, failure to display the fair housing poster is initially considered sufficient evidence in a lawsuit to show that a broker practiced discriminatory housing practices. [24 CFR §110.30]

A real estate broker who follows HUD advertisement guidelines and displays the fair housing poster is less likely to practice a discriminatory activity.

The fair housing poster assures potential sellers/landlords and buyers/tenants the broker does not unlawfully discriminate in the services he offers.

Also, the broker following HUD advertising and poster guidelines is in a better **position to defend** himself against a fair housing lawsuit.

Complying with HUD guidelines better assists the real estate broker to avoid prima facie violations of fair housing laws.

Use of the fair housing poster indicates to the public the broker's invitation to work with all individuals.

Trust Funds

Chapter 14 — Trust funds overview

This chapter presents an insight into trust funds and their treatment in the hands of a broker.

For a further discussion of this topic, see Chapter 1 of the "Trust Funds" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 14 Outline

Handling of funds belonging to others
Identification of trust funds
Managing the trust funds
Handling cash and checks
Identifying the owner

Chapter 14 Terms

Conversion	*Recordkeeping*
Funds	*Subaccount ledgers*
Illegally commingled	*Trust funds*
Owner's statement	

Handling of funds belonging to others

In the course of his practice, a real estate licensee often finds himself in situations where he is handling other people's items which have or evidence monetary value, called *funds*. **Funds** belonging to others which a broker and his agents handle when acting as agents in a transaction are called *trust funds*. **Trust funds** include:

- rents and security deposits collected under a property management agreement;
- good faith deposits tendered by a buyer with an offer to purchase;
- fees and costs handed to the broker in advance of his or another's performance of agreed-to services;
- loan payments and funds on contract collection and loan brokerage; and
- any other personal property of value.

Trust funds may not be treated casually, without a sense of security for their **safekeeping**. **Recordkeeping** and accounting requirements are imposed on brokers when they receive, transfer or disburse trust funds.

This chapter familiarizes brokers and their agents with the requirements and procedures for the handling of trust funds. Trust fund aspects a real estate licensee needs to know include:

- general laws and regulations defining and governing broker-held trust funds;
- special rules relating to the handling of advance fees and costs;
- how to open and operate a trust account; and
- recordkeeping and accounting procedures.

Identification of trust funds

Brokers, while acting on behalf of others in their capacity as agents in real estate transactions, receive funds to be **held in trust**. These funds, called *trust funds,* include:

- deposits on offers to purchase and applications to rent or borrow;
- fees advanced for any brokerage services to be provided in the future;
- funds advanced for future costs;
- funds from sellers, borrowers and landlords as reserves to cover future costs;
- rental income and tenant security deposits;
- funding for a loan or the purchase of real estate; and
- proceeds from a sale or financing.

Trust funds are received by a broker, or by an employee acting on behalf of the broker, as part of a transaction in which the broker is acting as an agent. Employees acting on behalf of a broker include sales agents, associated brokers, resident property managers and office personnel.

Trust funds include any *item or evidence of value* handed to the broker or the broker's employee while acting as an agent in a real estate transaction.

For example, a buyer enters into a purchase agreement. The buyer's good faith deposit is in the form of a **bag of gems** that is handed to the broker. The dollar value of the gems will apply toward the purchase price on closing.

Must the broker handle the bag of gems as trust funds?

Yes! All **items of value** received by the broker as part of a transaction for which a real estate license is required, regardless of form, are trust funds subject to special handling — safekeeping and recordkeeping. Trust funds come in many forms, including checks, precious metals/stones, stocks/bonds, collectibles, promissory notes and any other item or evidence of value. [Calif. Business and Professions Code §10145]

Managing the trust funds

Now consider a broker who enters into a property management agreement with an owner of income-producing real estate. Management services to be performed by the broker under his license include locating tenants, collecting rent and deposits, and disbursing funds for payment of operating expenses and installments on a trust deed loan encumbering the real estate.

The broker is further authorized to withdraw his fee and send any funds remaining to the owner.

The broker takes possession of the property under the property management agreement. The broker locates several new tenants and collects monthly rent and deposits.

The broker deposits the rent and security deposits he receives into his **general account**. He then enters the amount of each transaction as **trust funds** on the client's subaccount ledger.

Although sufficient funds are held in the client's subaccount to meet operating expenses and make the loan payment, the broker first withdraws his fee before making the loan payment authorized by the owner. The disbursement of the brokerage fee reduces the balance on the client's ledger below the amount needed to make the loan payment.

The broker then issues a check to the lender for the loan payment. The check bounces due to insufficient funds remaining in the broker's general account. The owner is notified by the lender and contacts the broker who provides funds to cover the loan payment.

However, when the rent and security deposits collected on behalf of his client were deposited into his general account rather than a trust account, the broker *illegally commingled* the owner's funds with his funds, even though a subaccount ledger for the client's trust funds was maintained.

Also, withdrawal of the brokerage fee before paying all other obligations the broker agreed to disburse on behalf of the owner, including payment on the loan, is a *conversion* of the client's funds to the broker's own use, a breach of the agency duties owed to the client. The brokerage/management fee is to be paid last, after agreed-to services have been performed, including all authorized disbursements.

Further, the broker misrepresented the availability of immediate funds, a fraud which is grounds for the revocation or suspension of his license, by writing a check for the loan payment when he knew insufficient funds existed in the account to cover the check. [**Apollo Estates, Inc.** v. **Department of Real Estate** (1985) 174 CA3d 625]

Consider a broker who maintains a brokerage trust account that holds loan payments received by the broker while servicing loans on behalf of trust deed investors.

The broker pledges the trust account to secure a personal loan from the same bank which holds the trust account.

The broker defaults on the loan, and the bank seizes the trust account funds.

An investor seeks to recover his trust account funds from the bank, claiming the bank's seizure of the funds is a *conversion* since trust funds cannot be taken to satisfy the broker's personal debt.

The bank claims the seizure of the trust account is not a conversion since it exercised its right to an offset under the security agreement.

Is the investor entitled to recover his portion of the trust funds?

Yes! The trust funds belong to the investor and must be returned. The bank's right to an offset for the broker's personal debt to the bank does not extend to seizure of funds held for others in the broker's trust account. [**Chazen** v. **Centennial Bank** (1998) 61 CA4th 532]

Handling cash and checks

Funds received in the form of cash or checks made payable to the broker while acting as an agent in a transaction are trust funds which must be:

- deposited into the broker's trust account;
- held undeposited as instructed; or
- endorsed and handed to others entitled to the funds.

Further, the broker has a duty to **secure trust funds** that are not in the form of cash or checks, such as gems, coins, notes or other personal property, from loss or damage after he receives them. These nonnegotiable types of trust funds cannot be deposited in a bank account.

Thus, the broker should place the nonnegotiable items in a safe or safe-deposit box for safekeeping until they are delivered to others.

Trust funds received in the form of checks or cash may only be used for expenditures authorized and incurred for the benefit of the owner of the funds.

Further, the broker must **regularly account** to the owner on the status, expenditure and location of the negotiable trust funds, called an *owner's statement*.

Prior to the end of the **third business day** following the day the broker receives negotiable trust funds (cash or checks) the broker, unless instructed in writing to the contrary, must deposit the funds:

- with the **person or escrow** depository entitled to the funds (as payee or by endorsement); or

- in a **trust account** maintained by the broker at a bank or other state-recognized depository. [Bus & P C §10145; Department of Real Estate Regulation §2832(a)]

Also, when an agent of the broker accepts trust funds on behalf of the broker, the agent must immediately deliver the funds to the broker, unless directed by the broker to:

- deliver the trust funds to the person or the escrow entitled to the funds; or

- deposit the trust funds into the broker's trust account. [Bus & P C §10145(c)]

For example, when a broker negotiates the purchase or lease of real estate, he usually receives a check as a good faith deposit on an offer to purchase or lease.

The broker may hold the check undeposited until an event occurs, such as the offer is accepted or escrow is opened, if:

- the check is made payable to someone other than the broker; or

- the check is made payable to the broker with **written instructions**, typically from the buyer or tenant, to hold the check undeposited until acceptance of the offer or escrow is opened; **and**

- the person to whom the offer is submitted, usually the seller or landlord, is informed the check for the good faith deposit is being held by the broker when the offer is submitted. [DRE Reg. §2832(c)]

The instructions to hold the check undeposited until acceptance are included in the terms for receipt of the deposit contained in the offer to purchase or lease. [See **first tuesday** Form 150 §1]

Also, after a buyer's offer is accepted, the broker may continue to hold the buyer's check for the good faith money undeposited if the seller gives the broker written instructions to continue to hold the check undeposited.

However, without instructions to further retain the check undeposited, the broker must deposit or deliver the funds by the end of the **next business day** after acceptance:

- to the payee entitled to the funds, such as a title company or escrow;

- into the broker's trust account at a bank or other state- recognized depository, such as a thrift; or

- to an escrow depository on the broker's endorsement, if the broker is the payee and does not want to deposit and disburse from his trust account to escrow. [DRE Reg. §2832]

Identifying the owner

A broker must at all times know who owns and controls the funds held in his trust account. Trust funds can only be disbursed on the authorization of the owner of the funds. *Subaccount ledgers* are set up to identify the owner of funds and the amount held for the owner.

However, persons other than the owner of the trust funds may have an interest in the funds. If so, their authorization is also required to withdraw the funds.

For example, a buyer, as a good faith deposit on an offer to purchase, issues a check payable to the broker with instructions in the purchase agreement to hold the check undeposited until acceptance of the offer.

The seller accepts the buyer's offer and the broker deposits the check in his trust account as funds held on behalf of and owned by the buyer.

The buyer is unable to obtain a purchase-assist loan to fund the purchase. The buyer cancels the transaction, consistent with the loan contingency provision in the purchase agreement. However, the seller does not sign mutual cancellation instructions or other instructions to authorize disbursement (return) of the buyer's deposit. [See **first tuesday** Form 183]

The buyer then makes an offer to purchase real estate owned by another seller, which is accepted.

To obtain funds to close escrow on the second transaction, the buyer makes a demand on the broker to transfer the buyer's good faith deposit on the first transaction from the trust account to the escrow handling the second transaction.

The broker refuses to withdraw the buyer's good faith deposit from his trust account without further instructions from the seller under the purchase agreement cancelled by the buyer.

Did the broker act correctly when retaining the buyer's good faith deposit?

Yes! When a buyer's offer, which includes receipt of a good faith deposit, **is accepted** by a seller and the buyer's good faith deposit is placed in the broker's trust fund account (or the purchase escrow), the buyer's funds may not be withdrawn without written authorization signed by both the buyer and seller.

If funds are disbursed without mutual instructions, the broker is liable to the seller for losses due to an improper release of the funds. [**Mullen** v. **Department of Real Estate** (1988) 204 CA3d 295]

Disclosures

Chapter 15 Property related disclosures

This chapter clarifies a broker's use of unverified information when marketing real estate.

For a further discussion of this topic, see Chapter 3 of the "Ethics" section of Agency, Fair Housing, Trust Funds, Ethics and Risk Management.

Chapter 15 Outline

Sold "as-is" is a prohibited disclaimer
Real estate size and boundaries must be accurately represented
Knowingly misrepresenting potential use
Marketability disclosure

Chapter 15 Terms

"As-is"	*Negligent misrepresentations*
General duty	*Public records*
Inspect and disclose	*Timely disclose*

Sold "as-is" is a prohibited disclaimer

A broker and his sales agents must disclose the physical nature and condition of a property when soliciting an offer to purchase.

Brokers and agents have a duty to *timely disclose* to all parties involved in a real estate transaction any significant physical aspects of a property that may affect the property's market value.

To comply with this duty, the seller's broker (or seller) of a one-to-four unit residence must provide the buyer with a Transfer Disclosure Statement (TDS) prior to making an offer and disclose all defects then known to the broker or the seller. [Calif. Civil Code §§1102 et seq; see **first tuesday** Form 304]

To be effective, property disclosures must be made to the buyer before offers are prepared and prices agreed to. If not, the buyer may:

1. Cancel on discovery of the broker's failure to previously disclose.

or

2. Close escrow and seek recovery of the costs to cure the belatedly disclosed and previously known defects, unless a contingency exists in the purchase agreement for further approval of the property's condition.

Any attempt to have the buyer waive his right to the mandated property disclosure statement is unenforceable. Failure to disclose property conditions is against public policy. [CC §1102]

The seller of one-to-four unit residential property must always prepare and deliver a Transfer Disclosure Statement (TDS). [See **first tuesday** Form 304]

Further, a broker has a general duty to all parties in any type of sales transaction to disclose at the earliest possible moment his awareness of any property defects.

Public policy prohibits the sale of one-to-four unit residential property "as-is," causing most form publishers to eliminate boilerplate "as-is" clauses. [CC §1102.1]

Real estate size and boundaries must be accurately represented

Consider a broker who is the exclusive agent of a buyer in the purchase of a one-to-four unit residential property. Without first receiving a survey or title report to verify his representations, the broker advises the buyer about the amount of acreage and the extent of an easement on the property. A further-approval contingency calling for the buyer to confirm the representations is not included in the purchase agreement. The buyer purchases the property, relying on the broker's size and easement representations of the property.

More than two years after closing, the buyer discovers the acreage and easement representations made by the broker are false. The property is worth less than the price paid.

The buyer seeks to recover the difference in property value from the broker. The broker claims the buyer's recovery is barred by a two-year statute of limitations for breach of a broker's agency duty to **inspect and disclose** defects on one-to-four unit residential property.

The buyer claims his action is not time-barred since the two-year statute of limitations only applies to *negligent misrepresentations*, not to the recovery of a loss caused by the broker's intentional misrepresentations about facts related to the property's physical condition.

Here, the buyer is entitled to recover his loss in property value. The broker misrepresented the property's size and easement without first confirming what they consisted of, an intentional misrepresentation. The two-year statute of limitation only applies to a broker who inspects the property and, as a result of the inspection, *negligently fails* to disclose facts that a reasonably diligent on-site inspection would have revealed.

Here, the broker made representations *as fact* without first verifying the information or advising the buyer of his source of information and that the information was not verified. Thus, a three-year statute of limitations for intentional misrepresentation applies, commencing on the date the buyer discovers the falsity of the broker's representation. [**Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18]

Knowingly misrepresenting potential use

A broker and his agents must accurately represent the title restrictions (CC&Rs) and potential use (zoning) of real estate to a prospective buyer or tenant.

For example, a seller's residence has a detached garage which has been converted into an apartment. The seller lists his property for sale with a broker.

The seller built and rents out the apartment in violation of zoning ordinances. The broker does not visually inspect the property to assure himself the apartment is up to building code nor does he confirm that the rental activities comply with zoning ordinances known to him.

The broker induces a buyer to pay a higher price than the residence alone is worth, representing as an incentive the existence of rental income from the apartment. The purchase agreement does not contain a further-approval contingency to confirm that the rental income will be available, and if not, to cancel the agreement.

After escrow closes, the city notifies the buyer the garage apartment is being rented in violation of zoning ordinances. The buyer is forced to quit renting out the apartment, suffering a loss in value of the property.

Here, the broker is liable for the part of the purchase price the buyer paid in excess of the fair market value of the residence. The broker failed to determine the accuracy of his rental income disclosure by first determining whether zoning conditions limited the buyer's use of the property. [**Barder** v. **McClung** (1949) 93 CA2d 692]

The broker, marketing property other than a one-to-four unit residential property, must determine and disclose to the buyer any use restrictions on the property (e.g., zoning ordinances, easements, CC&Rs, title conditions) which may interfere with the buyer's intended use as disclosed to the broker.

Additionally, the broker's duty to disclose a known potential future use of the property extends beyond disclosure of title and zoning conditions and their affect on the future use of property.

For example, a buyer is interested in purchasing undeveloped property for commercial development.

The property is located next to a maintenance yard owned by the state.

The seller's broker has been previously contacted by the state regarding its intent to acquire the property to expand the maintenance yard when funds for the acquisition become available.

During purchase negotiations, the buyer asks the seller's broker if the state is interested in the property. The broker informs the buyer the state has no interest in acquiring the property.

The buyer enters into a purchase agreement with the seller. During escrow, the buyer has plans drawn and obtains the necessary permits for development and construction on the property.

Just before escrow closes, the buyer discovers the state intends to acquire the property — by condemnation if necessary.

The buyer proceeds to take title to the property and later grants the property to the state in a condemnation proceeding.

Here, the broker is liable for the out-of-pocket losses incurred by the buyer for his loss of use of the property, as well as punitive damages for the broker's intentional failure to disclose the state's interest in acquiring the property. The buyer relied on the broker's information regarding the state's activities when he determined whether the property was suitable for his future development plans. [**People** v. **Grocers Wholesale Co.** (1989) 214 CA3d 498]

Marketability disclosure

A broker and his agents must advise a prospective buyer or tenant of any known facts that will affect the value or desirability of the purchased or rented property.

Four categories of conditions contribute to or detract from the value of property:

1. Physical condition of soil and improvements.

2. Land use and title conditions.

3. Operating income and expenses.

4. Location hazards and surrounding area impact.

For example, a buyer seeks property for the purpose of increasing his personal income and wealth.

A broker recommends an apartment complex as the source of additional spendable income and equity buildup for the buyer.

The property's scheduled rental income is represented to be far greater than the actual income. Additionally, the broker contends the property is in excellent physical condition with no deferred maintenance. It is not.

The broker makes these representations based on information received from the seller. The broker does not investigate maintenance, expense, and income records of the property to check the accuracy of the seller's representations. More importantly, the broker does not advise the buyer that the seller is the source of the property information and that he has not confirmed the information.

At the urging of the seller, the buyer is dissuaded from inspecting the property by the broker.

Relying solely on the broker's representations as to the operating income and condition of the property, the buyer purchases the property.

After closing, the buyer realizes the operating income is far less than the scheduled income stated on the property operating statement. The buyer discovers tenants are delinquent in the payment of rent and incurs deferred maintenance expenses — all of which seriously reduce the projected net spendable income.

Eventually, the buyer defaults on his trust deed and loses the property in foreclosure.

A broker marketing property as an income-producing investment owes a duty to a buyer to research whether the property produces adequate income to meet expenses. Alternatively, the broker may include a contingency provision in the purchase agreement calling for the buyer to confirm the representations or cancel the agreement prior to closing.

The broker cannot merely pass on the statements made by the seller as to the property's condition and income and expenses generated by the property. The broker must advise the buyer about the **source of the information** and the need for further investigation. Thus, the broker is liable to the buyer for the buyer's lost property value. [**Ford** v. **Cournale** (1973) 36 CA3d 172]

A broker analyzes the suitability of income property by preparing or having the seller prepare an Annual Property Operating Data Sheet (APOD) and reviewing it with the buyer. [See **first tuesday** Form 352]

A completed APOD should be prepared when listing income property and attached to the listing agreement as an addendum signed by the seller.

In addition to income and expense information provided in the APOD, the broker should inspect the property for quality of income, deferred maintenance and desirability of location, as well as check for any title or zoning conditions which might interfere with the buyer's intended use of the property.

Another fact affecting the value and desirability of the property is the existence of due-on-sale clauses in new or existing trust deeds and whether the lender will call or recast the loan by adjusting rates and rescheduling payments.

A broker has a duty to investigate the accuracy of all representations he makes to buyers or lenders regarding a property's physical condition, use and operating expenses, unless he discloses the source of his information and the fact he has not investigated or confirmed the representations.

However, a broker of one-to-four unit residential property is relieved of the responsibility of verifying the representations regarding property conditions he receives from others and passes on to buyers as long as the source of information is disclosed to the buyer.

The source typically is the seller, the seller's broker or a home inspector. [CC §§2079 et seq.]

Chapter 16 Due diligence obligations

This chapter focuses on the due diligent conduct owed a seller or buyer on the exclusive employment of a broker and his sales agents.

For a further discussion of this topic, see Chapter 21 of Real Estate Practice.

Chapter 16 Outline

The duty owed to clients
Maintaining the client file
Guidelines and checklists
Duty owed the DRE to keep records

Chapter 16 Terms

Activity sheet	*Due diligence obligations*
Best-effort obligation	*Material facts*

The duty owed to clients

Every exclusive listing agreement entered into by an agent on behalf of his broker is an employment which creates a client relationship. The employment imposes **special agency (fiduciary) duties** on the broker and the agent, owed to the client, to use *due diligence* in a continuous effort to meet the objective of the employment, be it to buy, sell, lease or finance an interest in real estate. [See **first tuesday** Form 102 §1.2]

The promise of **due diligence** is the consideration a broker and his agents give their client to render services in exchange for employment as the *exclusive representative* of the client to locate the "match" sought by the client. If the promise to use diligence in the employment is not stated in the exclusive listing agreement, it is **implied** as existing in the relationship.

The broker with authority to be the exclusive representative of a client must take reasonable steps to promptly gather all *material facts* about the property in question which are **readily available** to the broker or the broker's agent. After gathering factual information about the integrity of the property, the broker's agent proceeds to do every reasonable and ethical thing to pursue, with utmost care, the purpose of the employment.

In contrast to an exclusive listing, a broker and his agents entering into an **open listing** are not committed to render any services at all. The broker and his agents only have a *best-effort obligation* to act on the employment.

However, when an agent holding an open listing enters into preliminary negotiations, such as an exchange of property data, a due diligence obligation arises to provide the utmost care and protection of the client's best interests. Having **acted on the open listing**, the agent must now inspect the property and gather all readily available information on the property under consideration.

Once the agent actually begins to perform services under an open listing entered into by a buyer or seller, the agent has **acted on the employment** and the due diligence standards of duty owed to the client apply to his future conduct.

Maintaining the client file

Typically, the agent who produces a listing (and thus his broker's right to a fee) becomes the agent in the broker's office who is responsible to the broker for the care and maintenance of the client's file.

On entering into a listing, a **physical file** must be set up to house information and document all the activity which arises within the broker's office due to the existence of the listing. For example, the file on a property listing should at least contain the original listing agreement, its addenda and all the property disclosure documents the seller and his agent provide to a prospective buyer before the seller accepts an offer to buy.

The file needs an **activity sheet** for entry of information on all manner of file activity. Any paperwork, notes, messages, billings, correspondence, email printouts, fax transmissions, disclosure sheets, worksheets, advertising copy, tear sheets, copies of offers/counteroffers and rejections, and all other related documentation are to be kept in the file. Nothing occurs as a result of the client employment which is not to be put in and retained in the file.

The file is the **broker's file**, not the seller's agent's file, although it will likely remain with the seller's agent until close of a sale on the listed property or the listing expires unrenewed. The agent hands the broker the completed file on close of escrow, usually a **condition precedent** to payment of the agent's share of the fee received by the broker.

Guidelines and checklists

Guidelines used to build a file's content are available in the many forms, such as checklists prepared by a broker or his listing coordinator, a transaction coordinator's (TC's) closing checklist, escrow worksheets, work authorization forms, advance fee and advance cost checklists, or income property analysis forms. [See **first tuesday** Form 403]

Checklists belong in the file to be reviewed periodically by the agent, office manager, TC or employing broker for work which can be done to better service the listing and earn a fee.

This chapter discusses some — but certainly not all — steps a broker and his agent might undertake to fulfill their employment responsibilities owed to the client. They include:

1. A **property profile** of the seller's title from a title company in order to identify all owners needed to list, sell and convey the property.

2. A **condition of property** disclosure sheet (Transfer Disclosure Statement) filled out and signed by the seller. [See Chapter 18; see **first tuesday** Form 304]
3. A **home inspection report** (by a home inspector) paid for by the seller and attached to the condition of property statement (TDS) before the seller's agent signs the TDS. [See Chapter 19]
4. A **natural hazard disclosure** (NHD) on the property from a local agency or a vendor of NHD reports, paid for by the seller, and reviewed and signed by the seller and the listing agent. [See Chapter 20; see **first tuesday** Form 314]
5. An **annual property operating disclosure** (APOD) statement covering the expenses of ownership and any income produced by the property, filled out and signed by the seller, together with a rent roll and copies of lease forms which the owner uses, to be included in the listing package only after reviewing the seller's data. [See **first tuesday** Form 352, 306 and 562]
6. Copies of all the Covenants, Conditions and Restrictions (CC&Rs), disclosures and assessment data from any **homeowners' association** involved with the property. [See Chapter 25; see **first tuesday** Form 150 §11.9]
7. A **termite report** and clearance paid for by the seller.
8. Any replacement or **repair of defects** noted in the home inspection report or on the TDS, as authorized and paid for by the seller.
9. An occupancy **transfer certificate** (including permits or the completion of retrofitting required by local ordinances) paid for by the seller.
10. A statement on the amount and payment schedule for any special district property **improvement bonds** which are liens on the property (shown on the title company's property profile).
11. A **visual inspection** of the property and a survey of the surrounding neighborhood by the seller's agent to become informed about readily available facts affecting the marketability of the property.
12. **Advising** the seller about the marketability of the listed property based on differing prices and terms for payment of the price, and for property other than one-to- four residential units, the financial and tax consequences of various sales arrangements which are available by using alternative purchase agreements, options to buy, exchange agreements and installment sales.
13. A **marketing (listing) package** on the property compiled by the seller's agent and handed to prospective buyers or buyer's agents before the seller accepts any offer to purchase the property, consisting of copies of all the property disclosures required to be handed to prospective buyers or the buyer's agent by the seller and seller's broker.
14. A **marketing plan** prepared by the seller's agent and reviewed with the seller for locating prospective buyers, such as by distributing flyers, disseminating property data in multiple listing services, newspapers and periodicals, broadcasts at trade meetings attended by buyer's agents, press releases to radio or television, internet sites, posting "For Sale" signs on the premises, hosting open house events, posting on bulletin boards, mailing to neighbors and using all other advertising media available to reach prospective buyers.

15. A **seller's net sheet** prepared by the seller's agent and reviewed with the seller each time pricing of the property is an issue, such as when obtaining a listing, changing the listed price, reviewing the terms of a purchase offer or when substantial changes occur in charges or deductions affecting the net proceeds from a sale since the net sheet discloses the **financial consequences** of the seller's acceptance of a purchase agreement offer. [See **first tuesday** Form 310]
16. Informing the client of the listing agent's **sales activities** by weekly communications advising what specifically has been done during the past several days and what the seller's agent expects to do in the following days, as well as what the seller can do in response to comments taken by the seller's agent from buyers and their agents, and to changes in the real estate market.
17. Keeping records in a client file of all activities and documents generated due to the listing.

Duty owed the DRE to keep records

All records of an **agent's activities** on behalf of a buyer or seller during the listing period must be retained by the agent's broker for three years. [Bus & P C §10148]

The **three-year period** for retaining the buyer's or seller's activity file for Department of Real Estate (DRE) review begins to run from the closing date of a sale or, if a sale does not occur, from the date of the listing.

The records must be available for inspection by the Commissioner of Real Estate or his representative, or for an audit the Commissioner may order.

Chapter 17 — The seller's agent and the prospective buyer

This chapter distinguishes a seller's agent's limited, nonfiduciary general duty from a buyer's agent's special fiduciary agency duty owed to all prospective buyers.

For a further discussion of this topic, see Chapter 22 of Real Estate Practice.

Chapter 17 Outline

General duty to voluntarily disclose
Gathering facts on adverse features
The pass-through of filtered information
The dumb agent rule for SFRs
In response to an inquiry
Minimum level of disclosure

Chapter 17 Terms

Adverse facts	*General duty*
Dumb agent rule	*Risk avoidance procedures*

General duty to voluntarily disclose

A seller's broker, also known as a *listing broker,* and his agents have a special fiduciary agency duty, owed solely to a seller who has employed the broker, to diligently market the listed property for sale. The objective of this employment is to locate a prospective buyer who is ready, willing and able to acquire the property on the listed terms.

On locating a prospective buyer, either directly or through a buyer's agent, the seller's agent, also known as a *listing agent,* owes the prospective buyer, and thus also the buyer's agent, a limited, non-client *general duty* to voluntarily provide information on the listed property, called disclosures.

What is limited about the duty is not the extent or detail to which the seller's agent may go to provide information, but the **minimal quantity of fundamental information** and data about the listed property which must be handed to the prospective buyer or the buyer's agent.

The information disclosed by the seller's agent need only be sufficient enough in its content to place the buyer on notice of facts which may have an adverse effect on the property's value or the buyer's use.

Thus, the disclosure obligations of the seller's agent to voluntarily inform prospective buyers about the fundamentals of the listed property act to limit the seller's agent's ability to engage in any conduct or means at hand to exploit the prospective buyer. The seller's agent may not:

- deliver up less than the minimum level of information to put the buyer on notice of the property's fundamentals;
- give unfounded opinions or deceptive responses in response to inquiries; or
- stifle inquires about the property while in the vigorous pursuit of the best financial advantage obtainable for the seller.

Gathering facts on adverse features

The methods for gathering *adverse facts* about the property's fundamental characteristics, as well as those facts which enhance value, which the seller's agent is specifically required to disclose on the sale of a one-to-four unit residential property, include:

- conducting a **visual inspection** of the property to observe conditions which might adversely affect the market value of the property and to enter any observations of adverse conditions on the seller's Condition of Property (Transfer) Disclosure Statement (TDS) — if not already noted on the TDS by the seller or if inconsistent with the seller's disclosures, regardless of whether a home inspector's report has been or will be obtained by the seller [Calif. Civil Code §2079];
- assuring **seller compliance** with the seller's duty to deliver statements to prospective buyers as soon as possible, i.e., disclosing a variety of routine facts about natural hazards (NHD), the condition of the property (TDS), environment hazards (TDS), Mello-Roos liens, lead-based paint, neighborhood industrial zoning, occupancy and retrofit ordinances, military ordnance locations, condo documents, etc., by providing the seller with statutory forms at the listing stage to be filled out, signed by the seller, and returned to the agent for inclusion in the marketing package to be handed to prospective buyers;
- **reviewing and confirming**, without further investigation or verification by the seller's agent, that all the information and data in the disclosure documents received from the seller are consistent with the seller's agent's knowledge about the information and data, and if not, correct the information and data, and if the seller's agent has reason to believe information might not be accurate, either investigate and clarify the information or disclose his uncertainty about the information to the seller and the prospective buyer in the documents;
- advising the seller on **risk avoidance procedures** by recommending the seller obtain third-party inspections of the property's condition and its components (roof, plumbing, septic, water, etc.), to reduce the exposure to claims by a buyer who might discover deficiencies in the property not known to the seller or the seller's agent or worse, they were known and not disclosed *prior to acceptance* of a purchase agreement, and on discovery make a demand on the seller (and the broker) to correct the defects or reimburse the buyer for the costs incurred to correct them; and

- **responding to inquiries** by the prospective buyer or buyer's agent into conditions relating to any aspect of the property with a full and fair answer of related facts known to the seller's agent which are or might be considered detrimental to the value of the property and does so without suppressing further investigation or inquiry by the buyer or the buyer's agent since the inquiry itself makes the subject matter a *material fact* about which the prospective buyer may want more information before completing negotiations or acquiring the property.

The pass-through of filtered information

A seller's agent's statutory duty owed to prospective buyers to disclose facts about the integrity of the physical condition of a listed one-to-four unit residential property is limited to his prior knowledge about the property and the observations he made while conducting his *mandatory visual inspection*. To complete the disclosure process, the seller's agent serves as a conduit through which property information provided by the seller is filtered before the seller's agent passes it on to the prospective buyer.

Accordingly, all property information received from the seller must be reviewed by the seller's agent for any inaccuracies or untruthful statements known or suspected to exist by the seller's agent. Corrections or contrary statements by the seller's agent necessary to set the information straight must be included in the document or the document corrected before the information may be used to market the property and induce prospective buyers to purchase.

The extent to which disclosures about the physical condition of the property must be made is best demonstrated by what the seller's agent is **not obligated to provide**. All else adversely affecting value and known to the seller's agent must be brought to the attention of prospective buyers.

On the other hand, buyer's agents must understand that seller's agents have no duty to investigate any of the information or data disclosed as provided by the seller — the seller's agent need not make an effort to authenticate its accuracy or truthfulness before passing it on to the prospective buyer.

However, as a minimum effort to be made before handing a prospective buyer information received from the seller, the seller's agent must:

- review the information received from the seller;
- include comments about the agent's actual knowledge and observations he made during his visual inspection of the property which expose the inaccuracies, inconsistencies, false nature or omissions in the seller's statements; and
- identify the source of the information as the seller.

The dumb agent rule for SFRs

A seller's agent on a one-to-four unit residential property owes **no affirmative duty** to a prospective buyer to gather or voluntarily provide the prospect with any facts unknown to the seller's agent about:

- the property's *title conditions*, consisting of encumbrances which a preliminary title report would disclose, such as easements, Covenants, Conditions and Restrictions (CC&Rs), legal descriptions, trust deed provisions, etc., other than assuring compliance by the seller with disclosures about liens for improvement district bonds, such as Mello-Roos bonds;
- the **operating expenses** for the property (and any tenant income) the buyer will experience during ownership, such as utilities, sanitation, property taxes, yard and pool maintenance, insurance, etc., except the statutory disclosures the seller must make about any fire hazard clearance requirements which exist due to the property's location (NHD) [See **first tuesday** Form 314];
- the **zoning** or other **use restrictions** which may affect the buyer's future use of the property, except for the existence of industrial zoning which affects the property, and nearby military ordnance locations;
- the **income tax aspects** of the buyer's acquisition (or seller's disposition) of the property, such as limitations on interest deductions, avoidance of profit tax by exclusion or exemption on the sale of other property (on which the purchase of the listed property may be contingent);
- the **suitability of the property** based on the facts disclosed to actually meet the buyer's objectives in the acquisition, be they financial, legal, possessory, etc.; and
- information or data on any **mixed use** of the property, such as acreage included in the purchase for use as subdividable lands, groves or other farming operations, or for use for tenant income or as a vacation rental.

Further, the seller's agent owes no duty to prospective buyers to give advice, make recommendations, offer suggestions, comment on the extent of the adversity of the (adverse) facts disclosed, offer assistance (locate boundaries), investigate (due diligence), state an opinion or explain the effect on the buyer of any facts about the property's physical, natural or environmental conditions which have been provided by the seller's agent.

However, **when asked** by the prospective buyer or a buyer's agent about any aspect, feature or condition which relates to the property or the transaction in some way, the seller's agent is duty-bound to respond fully and fairly to the inquiry. The response must include material facts known to the seller's agent about the subject matter of the inquiry and be free of half-truths and misleading statements.

Conversely, it is the buyer or the buyer's agent who has a **duty to care for and protect** the buyer's best interests in the purchase of property. The buyer's agent, not the seller's agent, must determine what due diligence efforts are necessary to learn the extent to which the facts disclosed by the seller's agent interfere with the buyer's expectations for the use and enjoyment of the property before allowing the buyer to make the decision to purchase or close escrow.

In response to an inquiry

A seller's agent on a one-to-four unit residential property owes no duty to a prospective buyer to address the existence, much less the nature, of an easement located on the listed property since they are public records.

However, when the seller's agent responds to an inquiry by the prospective buyer by providing information on the easement, he must state fully and fairly, without deceptive or misleading wording, his knowledge about the easement.

Further, he must:

- identify the source of his information if he has not confirmed its accuracy or correctness; or
- condition his response in such a way as to prevent the prospective buyer from justifying any reliance on the information without further investigation.

The buyer's inquiry is entitled to a response based on the seller's agent's working knowledge of the underlying facts or identification of the source of the information given. If the seller's agent lacks sufficient knowledge to comment, he is duty-bound to say so.

Minimum level of disclosure

A seller's agent locating a prospective buyer for his client's one-to-four unit residential property owes a duty to the prospective buyer to conduct a reasonably diligent visual inspection of the property for defects which adversely affect the value of the listed property. On completing the inspection, the seller's agent must note on the (seller's) TDS any defects observable or known to the seller's agent which are not already noted by the seller or are inconsistent with the seller's disclosures. The TDS is to be handed to prospective buyers as soon as practicable (ASAP). [CC §§2079 et seq.]

However, the visual inspection and investigation of one-to-four unit residential property by the seller's agent and the disclosure of his knowledge and observations excludes other readily available information not already known to the seller's agent, such as knowledge that would be obtained by:

- the inspection of areas reasonably and normally **inaccessible** to the broker;
- the investigation of **off-site areas** and areas surrounding the property; and
- the inquiry into or review of **public records** or permits concerning title or use of the property. [CC §2079.3]

However, the minimum disclosure rule for seller's agents does not apply to a buyer's broker or his agents, much less limit the buyer's agent's duty to fully and fairly inform and advise on what investigations the buyer should undertake. Further, the minimum one-to-four unit inspection and reporting requirements imposed on seller's agents excludes the common law duty still imposed on seller's agents of other types of property to further investigate and disclose to buyers or sellers any material facts he discovers regarding:

- title conditions;
- the financial consequences of owning the property, such as the property's operating costs; or
- the tax aspects of the transaction (seller only).

Chapter 18 — Condition of property: the owner's disclosures

This chapter identifies the affirmative duty of a seller and his listing agent to disclose their awareness and knowledge about the property's condition to a prospective buyer.

For a further discussion of this topic, see Chapter 24 of Real Estate Practice.

Chapter 18 Outline

Mandated TDS on one-to-four residential units
Delivery of the disclosure statement
Buyer's right to cancel
Include a home inspector
Seller's broker's mandatory inspection
Controlled and exempt sellers
Duty to disclose on exempt sales

Chapter 18 Terms

"As-is" provision	*Transfer Disclosure Statement*
Common law duty	*Visual inspection*
Exempt	
Home inspector	

Mandated TDS on one-to-four residential units

A **seller** of a one-to-four unit residential property must **complete and deliver** to a prospective buyer a statutory form called a *Transfer Disclosure Statement* (TDS), more generically called a Condition of Property Disclosure Statement. [Calif. Civil Code §§1102(a), 1102.3; see Figure 1]

The seller must prepare the mandatory TDS with **honesty and in good faith**, whether or not a seller's broker or agent is retained by the seller to assist in its preparation. [CC §1102.7]

When preparing the TDS, the seller sets forth any property defects **known or suspected** to exist by the seller.

Any conditions known to the seller which **negatively affect** the value and desirability of the property must be disclosed, even though they may not be preprinted on the TDS. Disclosures to the buyer are not limited to the items preprinted on the form. [CC §1102.8]

Any attempt to have the buyer **waive delivery** of the statutorily-mandated TDS, such as by use of an "as-is" provision in the purchase agreement, is *void* as against public policy. The words "as is" should never be used. The words imply a failure to disclose something known to the seller or the seller's agent, also known as a *listing agent.* [CC §1102.1(a)]

Delivery of the disclosure statement

While it is the seller who must prepare the TDS, it is the agent who obtains the purchase agreement offer from the buyer who must hand the buyer the seller's Condition of Property Disclosure Statement. If the sales transaction is directly between the seller and buyer, without the participation of an agent in negotiations, the seller has the obligation to deliver the TDS to the buyer. [CC §1102.12]

The failure of the seller or any of the agents involved to **deliver** the seller's TDS to the buyer will not invalidate a sale of property which has closed.

However, the seller and the seller's broker will be liable to the buyer for the amount of actual monetary losses caused by an undisclosed defect known to them, a point of law which has always existed. [CC §1102.13]

For the seller's disclosure statement to be an effective pronouncement, **material defects** in the integrity of the property must be disclosed to the buyer before the price of the property is agreed to by acceptance of an offer or counteroffer.

If the seller's statement is delivered to the buyer of a one-to-four unit residential property after the seller enters into a purchase agreement, the buyer has the right to:

- **cancel** the purchase agreement on discovery of undisclosed defects known to the seller and unobserved by the buyer or the buyer's agent (on an inspection) prior to acceptance [CC §1102.3];

- **make a demand** on the seller to correct the defects or reduce the price accordingly before escrow closes [See **first tuesday** Form 150 §11.2]; or

- **close escrow** and make a demand on the seller for the costs to cure the defects known to the seller and not disclosed prior to acceptance. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

Buyer's right to cancel

The Condition of Property Disclosure Statement is to be delivered to a buyer *as soon as practicable*, and in any event, before closing a sale. **Delivery** of the seller's TDS to the buyer is deemed to have been met if the TDS is attached to the purchase agreement offer made by the buyer or the counteroffer made by the seller. [CC §1102.3]

If the TDS is belatedly delivered to the buyer — after he enters into a purchase agreement — the buyer may, among other remedies, **elect to cancel** the purchase agreement under a statutory

Figure 1 ***first tuesday*** *Form 304 -*
Condition of Property - Transfer Disclosure Statement (TDS)

CONDITION OF PROPERTY
Transfer Disclosure Statement (TDS)

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

This disclosure statement is prepared for the following:
☐ Seller's listing agreement
☐ Purchase agreement
☐ Counteroffer ____________________
☐ ____________________
dated ____________, 20______, at ____________________, California,
entered into by ____________________,
and ____________________,
regarding property referred to as ____________________

____________________.

REAL ESTATE TRANSFER DISCLOSURE STATEMENT

THIS DISCLOSURE STATEMENT CONCERNS THE REAL PROPERTY SITUATED IN THE CITY OF ____________________, COUNTY OF ____________________, STATE OF CALIFORNIA, DESCRIBED AS ____________________

____________________.

THIS STATEMENT IS A DISCLOSURE OF THE CONDITION OF THE ABOVE DESCRIBED PROPERTY IN COMPLIANCE WITH SECTION 1102 OF THE CIVIL CODE AS OF ____________, 20______. IT IS NOT A WARRANTY OF ANY KIND BY THE SELLER(S) OR ANY AGENT(S) REPRESENTING ANY PRINCIPAL(S) IN THIS TRANSACTION, AND IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THE PRINCIPAL(S) MAY WISH TO OBTAIN.

I

COORDINATION WITH OTHER DISCLOSURE FORMS

This Real Estate Transfer Disclosure Statement is made pursuant to Section 1102 of the Civil Code. Other statutes require disclosures, depending upon the details of the particular real estate transaction (for example: special study zones and purchase-money liens on residential property).

Substituted Disclosures: The following disclosures and other disclosures required by law, including the Natural Hazard Disclosure Report/Statement that may include airport annoyances, earthquake, fire, flood, or special assessment information, have or will be made in connection with this real estate transfer, and are intended to satisfy the disclosure obligations on this form, where the subject matter is the same:
☐ Inspection reports completed pursuant to the contract of sale or receipt for deposit.
☐ Additional inspection reports or disclosures: ____________________

____

— PAGE ONE OF FIVE — FORM 304 —

— PAGE TWO OF FIVE — FORM 304 —

II

SELLER'S INFORMATION

The Seller discloses the following information with the knowledge that even though this is not a warranty, prospective Buyers may rely on this information in deciding whether and on what terms to purchase the subject property. Seller hereby authorizes any agent(s) representing any principal(s) in this transaction to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY THE SELLER(S) AND ARE NOT THE REPRESENTATIONS OF THE AGENT(S), IF ANY. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN THE BUYER AND SELLER:

Seller ☐ is, ☐ is not, occupying the property.

A. The subject property has the items checked below **(read across):***

☐ Range	☐ Oven	☐ Microwave
☐ Dishwasher	☐ Trash Compactor	☐ Garbage Disposal
☐ Washer/Dryer Hookups		☐ Rain Gutters
☐ Burglar Alarms	☐ Carbon Monoxide Device(s)	☐ Fire Alarm
☐ TV Antenna	☐ Satellite Dish	☐ Intercom
☐ Central Heating	☐ Central Air Conditioning	☐ Evaporator Cooler(s)
☐ Wall/Window Air Conditioning	☐ Sprinklers	☐ Public Sewer System
☐ Septic Tank	☐ Sump Pump	☐ Water Softener
☐ Patio/Decking	☐ Built-in Barbecue	☐ Gazebo
☐ Sauna	☐ Water-conserving plumbing fixtures	
☐ Hot Tub ☐ Locking Safe Cover*	☐ Pool ☐ Child Resistant Barrier*	☐ Spa ☐ Locking Safe Cover*
☐ Security Gate(s)	☐ Automatic Garage Door Opener(s)* Number of Remote Controls: _______	

Garage: ☐ Attached ☐ Not Attached ☐ Door Opener(s)* ☐ Carport ☐ Not Attached
☐ Electrical vehicle charging station ☐ Separately metered
Pool/Spa Heater: ☐ Gas ☐ Solar ☐ Electric
Water Heater: ☐ Gas* ☐ Private Utility or Oher:____________________

Water Supply: ☐ City ☐ Well
Gas Supply: ☐ Utility ☐ Bottled
☐ Window Screens ☐ Window Security Bars
☐ Quick-Release Mechanism on Bedroom Windows*

Exhaust Fan(s) in ____________________ 220 Volt Wiring in ____________________
Fireplace(s) in ____________________ Gas Starter ____________________
Roof(s): Type ____________________ Age:______ (approx.)
Other:____________________

____

Are there, to the best of your (Seller's) knowledge, any of the above that are not in operating condition?
☐ Yes ☐ No
If yes, then describe. (Attach additional pages if necessary): ____________________

____________________ ☐ Addendum attached.

— PAGE TWO OF FIVE — FORM 304 —

Scan this QR-Code for a PDF of the Form!

Figure 1 Continued

B. Are you (Seller) aware of any significant defects/malfunctions in any of the following? ☐ Yes ☐ No.

If yes, check appropriate boxes below.

☐ Interior Walls ☐ Ceilings ☐ Floor ☐ Exterior Walls ☐ Insulation ☐ Roof(s) ☐ Windows
☐ Doors ☐ Foundation ☐ Slab(s) ☐ Driveways ☐ Sidewalks ☐ Walls/Fences
☐ Electrical Systems ☐ Plumbing/Sewers/Septics
☐ Other Structural Components (Describe): ________

If any of the above is checked, explain. (Attach additional pages if necessary): ________

☐ Addendum attached.

*Installation of a listed appliance, device, or amenity is not a precondition of sale or transfer of the dwelling. The carbon monoxide device, garage door opener, or child-resistant pool barrier may not be in compliance with the safety standards relating to, respectively, carbon monoxide device standards of Chapter 8 (commencing with Section 13260) of Part 2 of Division 12 of, automatic reversing device standards as set forth in Chapter 12.5 (commencing with Section 19890) of Part 3 of Division 13 of, or the pool safety standards of Article 2.5 (commencing with Section 115920) of Chapter 5 of Part 10 of Division 104 of, the Health and Safety Code. Window security bars may not have quick-release mechanisms in compliance with the 1995 edition of the California Building Standards Code.

C. Are you (Seller) aware of any of the following:

1. Substances, materials or products which may be an environmental hazard such as, but not limited to, asbestos, formaldehyde, radon gas, lead-based paint, mold, fuel or chemical storage tanks, and contaminated soil or water on the subject property . . . ☐ Yes ☐ No
2. Features of the property shared in common with adjoining landowners, such as walls, fences, and driveways, whose use or responsibility for maintenance may have an effect on the subject property . . . ☐ Yes ☐ No
3. Any encroachments, easements or similar matters that may affect your interest in the subject property . . . ☐ Yes ☐ No
4. Room additions, structural modifications, or other alterations or repairs made without necessary permits . . . ☐ Yes ☐ No
5. Room additions, structural modifications, or other alterations or repairs not in compliance with building codes . . . ☐ Yes ☐ No
6. Fill (compacted or otherwise) on the property or any portion thereof . . . ☐ Yes ☐ No
7. Any settling from any cause, or slippage, sliding, or other soil problems . . . ☐ Yes ☐ No
8. Flooding, drainage or grading problems . . . ☐ Yes ☐ No
9. Major damage to the property or any of the structures from fire, earthquake, floods, or landslides . . . ☐ Yes ☐ No
10. Any zoning violations, nonconforming uses, violations of "setback" requirements . . . ☐ Yes ☐ No
11. Neighborhood noise problems or other nuisances . . . ☐ Yes ☐ No
12. CC&Rs or other deed restrictions or obligations . . . ☐ Yes ☐ No
13. Homeowners' Association which has any authority over the subject property . . . ☐ Yes ☐ No
14. Any "common area" (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others) . . . ☐ Yes ☐ No
15. Any notices of abatement or citations against the property . . .
16. Any lawsuits by or against the Seller threatening to or affecting this real property, including any lawsuits alleging a defect or deficiency in this real property or "common areas" (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others) . . . ☐ Yes ☐ No

If the answer to any of these is yes, explain. (Attach additional pages if necessary.): ________

☐ Addendum attached. [See **ft** Form 251]

D. 1. The Seller certifies that the property, as of the close of escrow, will be in compliance with Section 13113.8 of the Health and Safety Code by having operable smoke detector(s) which are approved, listed, and installed in accordance with the State Fire Marshal's regulations and applicable local standards.

2. The Seller certifies that the property, as of the close of escrow, will be in compliance with Section 19211 of the Health and Safety Code by having the water heater tank(s) braced, anchored, or strapped in place in accordance with applicable law.

Seller certifies that the information herein is true and correct to the best of the Seller's knowledge as of the date signed by the Seller.

Seller:________ Date:________, 20______

Seller:________ Date:________, 20______

III

SELLER'S AGENT'S INSPECTION DISCLOSURE

(To be completed only if the Seller is represented by an agent in this transaction.)

THE UNDERSIGNED, BASED ON THE ABOVE INQUIRY OF THE SELLER(S) AS TO THE CONDITION OF THE PROPERTY AND BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY IN CONJUNCTION WITH THAT INQUIRY, STATES THE FOLLOWING:

☐ Agent notes no items for disclosure.

Agent notes the following items: ________

Listing Broker: ________ DRE#:________
(Broker Representing Seller — Please Print)

By:________ Date:________, 20______
(Associate Licensee or Broker Signature)

IV

AGENT'S INSPECTION DISCLOSURE

(To be completed only if the agent who has obtained the offer is other than the agent above):

THE UNDERSIGNED, BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY, STATES THE FOLLOWING:

☐ Agent notes no items for disclosure.

Agent notes the following items:________

Selling Broker: ________
(Broker Obtaining the Offer — Please Print)

By:________ Date:________, 20______
(Associate Licensee or Broker Signature)

V

BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE AND/OR INSPECTIONS OF THE PROPERTY AND TO PROVIDE FOR APPROPRIATE PROVISIONS IN A CONTRACT BETWEEN BUYER(S) AND SELLER(S) WITH RESPECT TO ANY ADVICE/INSPECTIONS/DEFECTS.

A REAL ESTATE BROKER IS QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE, CONSULT YOUR ATTORNEY.

I/WE ACKNOWLEDGE RECEIPT OF A COPY OF THIS STATEMENT.	**I/WE ACKNOWLEDGE RECEIPT OF A COPY OF THIS STATEMENT.**
Date:________, 20______	Date:________, 20______
Buyer:________	Seller:________
Buyer:________	Seller:________
Buyer's Broker:	**Seller's Broker:**
Date:________, 20______	Date:________, 20______
Agent:________ (Broker Obtaining the Offer — Please Print)	Agent: ________ (Broker Representing Seller — Please Print)
DRE #: ________	DRE #: ________
By: ________ (Associate Licensee or Broker Signature)	By: ________ (Associate Licensee or Broker Signature)

SECTION 1102.3 OF THE CIVIL CODE PROVIDES A BUYER WITH THE RIGHT TO RESCIND A PURCHASE CONTRACT FOR AT LEAST THREE DAYS AFTER THE DELIVERY OF THIS DISCLOSURE IF DELIVERY OCCURS AFTER THE SIGNING OF AN OFFER TO PURCHASE. IF YOU WISH TO RESCIND THE CONTRACT, YOU MUST ACT WITHIN THE PRESCRIBED PERIOD.

A REAL ESTATE BROKER IS QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE, CONSULT YOUR ATTORNEY.

three-day right to cancel. The buyer's statutory cancellation right runs for three days following the day of the in-escrow (in-person) delivery of the disclosure statement (five days if delivered via mail). [CC §1102.3]

However, buyers are not required to cancel the purchase agreement and "go away" on their in-escrow receipt of an unacceptable TDS or home inspection report.

As an alternative to canceling the purchase agreement on receipt and review of the seller's disclosure statement, the buyer may **make a demand** on the seller to cure any material defect (affecting value) which was *known to the seller* and not disclosed or known to the buyer prior to entering into the purchase agreement.

The same rule holds for the seller's agent who has knowledge of defects and does not disclose the facts to the buyer before the buyer enters into the purchase agreement. [See **first tuesday** Form 269]

If the seller will not cure the defects, the buyer may close escrow and recover the cost incurred (or valuation lost) to correct the defect. The defects must be **known and undisclosed**, or inaccurately disclosed, by the seller at the time of acceptance of the purchase agreement. [Jue, *supra*]

Another alternative for the buyer is to complete the purchase by tendering a **price reduced** by the cost to repair or replace the defects known to the seller and undisclosed (or unconditionally misrepresented) on the date the purchase agreement was entered into. [See **first tuesday** Form 150 §11.2]

Include a home inspector

A competent seller's agent will aggressively recommend to his sellers that before the property is marketed they retain a **home inspector** to conduct a physical examination to determine the condition of the property and issue a report on his findings. [See Chapter 19]

A home inspector often detects and reports property defects overlooked by the seller and not observed during a visual inspection by the seller's agent. Significant defects which remain undisclosed tend to surface after closing as claims against the seller's broker for deceit. A home inspector troubleshoots for defects not observable to the untrained eye of a broker and his seller's agent. [Calif. Business and Professions Code §7195]

Seller's broker's mandatory inspection

A **seller's broker** (or the broker's agent) is obligated to personally carry out a *visual inspection* of the property and do so competently. The seller's disclosures on the Condition of Property Disclosure Statement are then reviewed by the broker or the seller's agent for discrepancies. They then add any information about their knowledge of material defects which have gone undisclosed by the seller (or the home inspector) and are known to the seller's agent or observed during the agent's inspection.

A buyer has **two years** from the date of possession to pursue the seller's broker and agent to recover losses caused by the broker's or his agent's **negligent failure** to disclose observable and

known defects affecting the physical condition and value of the property. Undisclosed defects permitting recovery are those which would have been observed by a reasonably competent broker during a visual on-site inspection. A seller's agent is expected to be as competent in an inspection as his broker would be. [CC §2079.4]

However, the buyer will be unable to recover money from the seller's broker if the seller's broker or agent inspected the property and would not have observed the defect and did not actually know it existed. [CC §1102.4(a)]

Following their mandatory visual inspection, the seller's broker or his agent might make some of their disclosures on the seller's TDS by relying on **specific items** covered in a home inspector's report. Should the items relied on later be contested by the buyer as incorrect or inadequate, the broker and his agent are entitled to indemnification from the home inspection company issuing the report. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

Controlled and exempt sellers

Unless a seller is *exempt*, sellers of one-to-four unit residential real estate are required to furnish buyers with a statutory Transfer Disclosure Statement filled out by the seller. [CC §1102]

Seller's brokers and their agents are never exempt from:

- conducting a **visual inspection** of a one-to-four unit residential property, sold or acquired on behalf of a seller or buyer [CC §2079]; and
- disclosing their **observations and knowledge** about the property on a TDS form or other separate document, whether or not the seller is exempt from using the form. [CC §1102.1]

Transactions which **exempt the seller** (but not the seller's agent) from preparing and delivering the statutory TDS to the buyer include transfers:

- by court order, such as probate, eminent domain or bankruptcy;
- by judicial foreclosure or trustee's sale;
- on the resale of real estate owned property acquired by a lender on a deed-in-lieu of foreclosure, or by foreclosure;
- from co-owner to co-owner;
- from parent to child;
- from spouse to spouse, including property settlements resulting from a dissolution of marriage;
- by tax sale;
- by reversion of unclaimed property to the state; and

- from or to any government agency. [CC §1102.2]

Duty to disclose on exempt sales

A seller who is exempt from the **use and delivery** of the statutory Condition of Property Statement to buyers still has a *common law duty* to prospective buyers to disclose all **known defects**.

In exempt transactions, the seller and seller's agent can use a separate document to make the disclosures, or they may use the TDS form to list the defects known or suspected by them to exist to avoid deceit. [CC §1102.1(a)]

The best property disclosure tool for exempt sellers is the preparation and delivery of the statutory disclosure form (and a property inspector's report) to prospective buyers or buyer's agents on every type of transaction. If the transaction is exempt or concerns property other than one-to-four residential units, as best practice the form should still be prepared and delivered by the seller's agent.

Chapter 19 — The home inspection report

This chapter introduces the seller's and seller's agent's use of a home inspection report to document the present physical condition of the listed property for prospective buyers.

For a further discussion of this topic, see Chapter 26 of Real Estate Practice.

Chapter 19 Outline

The seller's agent's marketing role
A home inspector's qualifications
Hiring a home inspector
The home energy rater
Reliance by buyers on the report
The home inspection contract
The inspection and report
The home inspector's conflicts of interest

Chapter 19 Terms

Home inspection report	*Noncontingent fee*
Home inspector	*Non-invasive examination*
Indemnification claim	*Ordinary care*
Material defect	*Professional liability insurance*

The seller's agent's marketing role

The task of gathering information about the condition of the property listed for sale and delivering the information to prospective buyers lies primarily with the seller's agent, also known as the *listing agent*. [Calif. Civil Code §2079]

Further, to retain control throughout the process of marketing, selling and transferring ownership, the seller's agent must be the one who requests the HIR (on behalf of the seller). The seller's agent will lose control over the marketing and closing process, and expose himself (and his seller) to claims of misrepresentation, when the buyer or the buyer's agent is the one who first orders the HIR.

As part of the seller's agent's management of the home inspection activity, the agent should be present while the *home inspector* carries out his investigation of the property. The agent can discuss the **home inspector**'s observations and whether his *findings are material* in that they affect the desirability, value, habitability or safety of the property, and thus its value to prospective buyers.

If the seller's agent cannot be present, then he should request that the home inspector call the agent before the HIR is prepared to discuss the home inspector's findings and any recommendations he may have for further investigation. On receipt and review of the report by the seller and seller's agent, any questions or clarifications they may have on its content is followed up by a further discussion with the home inspector, and if necessary, an amended or new report.

A home inspector's qualifications

Any individual who holds himself out as being in the business of conducting a home inspection and preparing a home inspection report on his findings during the inspection of a one-to-four unit residential property is a **home inspector**. No licensing scheme exists to set the minimum standard of competency or qualifications necessary to enter the home inspection profession. [Calif. Business and Professions Code §7195(d)]

However, general contractors, structural pest control operators, architects and registered engineers typically conduct home inspections and prepare reports as requested by sellers, buyers and their agents.

The duty of care expected of licensed members of these professions by prospective buyers who receive and rely on their reports is set by their licensing requirements and professional attributes, i.e., the skill, prudence, diligence, education, experience and financial responsibility normally possessed and exercised by members of their profession. These licensees are experts with a high level of duty owed to those who receive their reports. [Bus & P C §7068]

Home inspectors occasionally **do not hold** any type of license relating to construction, such as a person who is a construction worker or building department employee. However, they are required to conduct an inspection of a property with the same "degree of care" a reasonably prudent home inspector would exercise to locate material defects during their *physical examination* of the property and report their findings. Prospective buyers who rely on home inspection reports can expect a high level of competence from experts. [Bus & P C §7196]

However, a home inspector who is not a registered engineer cannot perform any analysis of systems, components or structural components which would constitute the practice of a civil, electrical or mechanical engineer. [Bus & P C §7196.1]

Hiring a home inspector

A seller's broker and agent can rely on items specified in a home inspection report (HIR) to prepare their TDS for delivery to prospective buyers.

Their reliance on an HIR prepared by an inspector relieves the seller and the seller's broker from liability for errors which are unknown to them to exist. However, to rely on the HIR, they must be free of simple negligence in the selection of the home inspector who inspects and prepares the HIR. Thus, the broker must exercise ordinary care when selecting the home inspector.

If **care in the selection** of a home inspector is lacking, then reliance on the HIR by the seller and agent preparing the TDS will not relieve the seller's broker or agent of liability for the home inspectors incompetence or error.

However, use of an HIR by the seller's agent does not relieve the agent (or his broker) from conducting their mandatory visual inspection. [CC §1102.4(a)]

Thus, the broker and agent must look into or be aware of whether the home inspector who prepares the report is qualified. The home inspector who holds a professional license or is registered with the state as a general contractor, architect, pest control operator or engineer is deemed to be qualified, unless the agent knows of information to the contrary.

When hiring a home inspector, the qualifications to look for include:

- educational training in home inspection related courses;
- length of time in the home inspection business or related property or building inspection employment;
- errors and omissions insurance covering professional liability;
- professional and client references; and
- membership in the California Real Estate Inspection Association, the American Society of Home Inspectors or other nationally recognized professional home inspector associations with standards of practice and codes of ethics.

Remember, the reason for hiring a home inspector in the first place is to assist the seller and the seller's agent to better represent the condition of the property to prospective buyers, and reduce the risk of errors.

Reliance by buyers on the report

A seller's agent requesting a home inspection report needs to advise the home inspector that the seller, broker and all prospective buyers of the property will be relying on the report. This disclosure will avoid later (unenforceable) claims by the home inspector that the report was intended for the sole use of the seller, broker or buyer who signed the home inspector's contract. [CC §1102.4(c)]

Consider a buyer under a purchase agreement who requests a home inspection report on the property being purchased. On receipt of the report, the buyer cancels the purchase agreement. Another prospective buyer interested in the property receives the same home inspection report from the seller's agent and relies on it to acquire the property.

However, the report fails to correctly state the extent of the defects. The second buyer discovers the errors and makes a demand on the home inspector who prepared the report for the first buyer to cover the cost to cure the defects which were the subject of the errors.

The home inspector claims the report was prepared only for use by the buyer who requested the report and no subsequent buyer can now rely on it, as stated in the home inspection contract under which the report was prepared.

Here, the home inspector knew the seller's agent also received the report and should have known that the agent would properly provide it to other prospective buyers if the buyer who ordered the report did not complete the purchase. A **home inspection report**, like an appraisal-of-value report or a structural pest control report, is not a confidential document.

Thus, all prospective buyers of the property are *entitled to rely* on the existing home inspection report.

This reliance by other prospective buyers imposes liability on the home inspector for his failure to exercise the level of care expected of a home inspector when examining the property and reporting defects. Liability for the defects is imposed regardless of the fact that the home inspection contract and report contained a provision restricting its use solely to the person who originally requested it. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

The home inspection contract

Provisions in a contract with a home inspector and his home inspection company which purport to limit the dollar amount of their liability for errors, inaccuracies or omissions in their reporting of defects to the dollar amount of the fee they received for the report are unenforceable.

Occasionally, a boilerplate provision in the home inspector's contract or the home inspection report will attempt to limit the buyer's period for recovery to one year after the inspection occurred.

However, any such limitation the home inspector places on time periods during which the buyer must discover and make a claim is unenforceable. The statutory four-year period is needed to provide time for buyers to realize the home inspector produced a faulty report. [**Moreno** v. **Sanchez** (2003) 106 CA4th 1415]

The inspection and report

A home inspection is a **physical examination** conducted on-site by a home inspector. The inspection of a one-to-four unit residential property is performed for a noncontingent fee.

The purpose of the physical examination of the premises is to identify material defects in the condition of the structure and its systems and components. **Material defects** are conditions which affect the property's:

- market value;
- desirability as a dwelling;
- habitability from the elements; and
- safety from injury in its use as a dwelling.

Defects are material if they adversely affect the price a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement. As the report may affect value, the investigation and delivery of the home inspection report to a prospective buyer must precede a prospective buyer's offer to purchase to be meaningful. [Bus & P C §7195(b)]

The home inspection is to be a *non-invasive examination* of the mechanical, electrical and plumbing systems of the dwelling, as well as the components of the structure, such as the roof, ceiling, walls, floors and foundations.

Non-invasive indicates there will not be an intrusion into the roof, walls, foundation or soil by dismantling or taking apart the structure which would disturb components or cause repairs to be made to remove the effects of the intrusion. [Bus & P C §7195(a)(1); see **first tuesday** Form 130]

The *home inspection report* is the written report prepared by the home inspector which sets forth his findings while conducting his physical examination of the property. The report identifies each system and component of the structure inspected, describes any material defects the home inspector found or suspects, makes recommendations about the conditions observed and suggests any further evaluation needed to be undertaken by other experts. [Bus & P C §7195(c)]

The seller's agent needs to make sure the report addresses the cause of any defect or code violation found which constitutes a significant defect in the use of the property or cost to remedy the defects. The report should also include suspicions the home inspector might have which need to be clarified by further inspections and reports by others with more expertise.

The agent, or anyone else, may also request that the home inspector conduct an inspection on the energy efficiencies of the property and include his findings in the report. On a request for an **energy efficiency inspection**, the home inspector will report on items including:

- the R-value of the insulation in the attic, roof, walls, floors and ducts;
- the quantity of glass panes and the types of frames;
- the heating and cooling equipment and fans;
- water heating systems;
- the age of major appliances and the fuel used;
- thermostats;
- energy leakage areas throughout the structure; and
- the solar control efficiency of the windows. [Bus & P C §7195(a)(2)]

The home inspector's conflicts of interest

The home inspector who prepares a home inspection report, the company employing the home inspector and any affiliated company may not:

- pay a referral fee or provide for any type of compensation to brokers, agents, owners or buyers for the referral of any home inspection business;
- agree to accept a contingency fee arrangement for the inspection of the report, such as a fee payable based on the home inspector's findings and conclusions in the report or on the close of a sales escrow;
- perform or offer to perform any repairs on a property which was the subject of a HIR prepared by them within the past 12 months; or
- inspect any property in which they have a financial interest in its sale. [Bus & P C §7197]

Chapter 20 Natural hazard disclosures by the seller's agent

This chapter demonstrates the use of the Natural Hazard Disclosure (NHD) Statement by sellers and seller's agents to fulfill their obligations to inform prospective buyers.

For a further discussion of this topic, see Chapter 28 of Real Estate Practice.

Chapter 20 Outline

A unified disclosure for all sales
Investigating the existence of a hazard
Broker uses experts to limit liability
Documenting compliance with NHD law
Delivery of the NHD to the buyer
No warranty, just awareness
Excluded sellers, not agents
Other disclosure statements distinguished
Other than one-to-four
Flood zones
Very high fire hazard severity zone
State Fire Responsibility Areas
Earthquake fault zones
Seismic hazards

Chapter20 Terms

Airport influence area	*Ordinary care*
Airport referral area	*Physical deficiency*
Alquist-Priolo Maps	*Public record*
As soon as practicable	*Restoration*
Deceit	*Seismic Hazard Zone*
Delivery	*Special flood hazard area*
Environmental hazards	*State Fire Responsibility Area*
Indemnification agreement	*Targeted property*
Natural Hazard Disclosure Statement	*Termination*
Natural hazard expert	*Very high fire hazard severity zone*

A unified disclosure for all sales

Natural hazards come with the **location** of a parcel of real estate, not with the man-made aspects of the property. Locations where a property might be subject to natural hazards include:

- special flood hazard areas, a federal designation;
- potential flooding and inundation areas;
- very high fire hazard severity zones;
- wildland fire areas;
- earthquake fault zones; and
- seismic hazard zones. [Calif. Civil Code §1103(c)]

The existence of a hazard due to the geographic location of a property affects its value and desirability to prospective buyers. Hazards, by their nature, limit a buyer's ability to develop the property, obtain insurance or receive disaster relief.

Whether a seller markets his property himself or lists the property with a broker, the seller must disclose to prospective buyers any natural hazards **known to the seller**, as well as those contained in **public records**.

To unify and streamline the disclosure by a seller (and his agent) about those natural hazards which affect a property, the California legislature created a statutory form entitled the *Natural Hazard Disclosure (NHD) Statement*.

The NHD form is used by a seller a seller's agent, also known as a *listing agent,* for their preparation (or acknowledgement of their review of a report prepared by an NHD expert) and disclosure of natural hazard information. The information is both known to the seller and seller's agent (and the NHD expert) and available to them as shown on maps in the public records of the local planning department. [CC §1103.2; see Form 314 accompanying this chapter]

Actual use of the NHD Statement by sellers and their agents is **mandated** on the sale of **one-to-four unit residential properties**, called *targeted properties*. Some sellers of targeted properties are excluded from mandatory use of the form, but never their agents. Thus, the form, filled out and signed by the seller (unless excluded) and the seller's agent, must be included in listing packages handed to prospective buyers on every one-to-four unit residential property.

Editor's note — Any attempt by a seller or seller's agent to use an "as-is" provision or otherwise provide for the buyer to agree to waive his right to receive the seller's NHD statement is void as against public policy. [CC §1103(d)]

Regarding excluded sellers and sales of property other than one-to-four unit residential property, use of the statutory NHD Statement by sellers and seller's agent s is an **optional** method for making their disclosure of natural hazard information to buyers.

However, delivery of the information by use of one form or another is not optional. A natural hazard disclosure is **mandated on all types of property**. [CC §1103.1(b)]

All sellers, and any listing or buyer's agent involved, have an initial common law duty owed to prospective buyers to disclose conditions on or about a property which are **known to them** and might adversely affect the buyer's willingness to buy or influence the price and terms of payment he is willing to offer.

Natural hazards, or the lack thereof, irrefutably affect a property's value and desirability to a prospective buyer. If a hazard is known to any agent (as well as the seller) or noted in public records, it must be disclosed to the prospective buyer before he agrees to purchase the property. If not disclosed, the buyer can cancel the transaction, called *termination*. And if the transaction has closed escrow, the buyer may **rescind** the sale and be **refunded** his investment, called *restoration*. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

Therefore, the need to prepare the seller's NHD statement in advance of locating a prospective buyer **must be anticipated** by the seller and seller's agent .

If the need is not anticipated, the NHD will not be prepared, signed and available for delivery to prospective buyers before an offer is accepted or a counteroffer is made, all requisites to delivery of the NHD *as soon as practicable*. [Calif. Attorney General Opinion 01-406 (August 24, 2001); CC §1103.3(a)(2)]

Investigating the existence of a hazard

Natural hazard information must be obtained from the *public records*. If not obtained, the seller and seller's agent cannot make their required disclosures.

To obtain the natural hazard information for delivery to prospective buyers, the seller and his agent are required to exercise *ordinary care* in gathering the information. They may gather the information themselves or the seller may employ an NHD expert to gather the information. When an expert is employed, he prepares the NHD form for the seller and his agent to review, add any comments, sign and deliver to prospective buyers. [CC §1103.4(a)]

Thus, the seller and seller's agent may obtain **natural hazard information**:

- directly from the **public records** themselves; or
- by employing a *natural hazard expert*, such as a geologist.

For the seller and the seller's agent to rely on an NHD report prepared by others, the **seller's agent** need only:

- **request** an NHD report from a reliable expert in natural hazards, such as an engineer or a geologist who has studied the public records (as some natural hazards clearly do not pertain to engineering or geology);

NATURAL HAZARD DISCLOSURE STATEMENT

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: The seller's listing broker (and the seller) of one-to-four residential units shall prepare a Natural Hazard Disclosure (NHD) and deliver it to prospective buyers prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

DATE:__________, 20_____, at ______________________________, California.

This disclosure statement is prepared for the following:

☐ Seller's listing agreement
☐ Purchase agreement
☐ Counteroffer
☐ ______________________________

dated __________, 20_____, at ______________________________, California,
entered into by ______________________________, as the ____________________,
regarding real estate referred to as ______________________________
______________________________.

Natural Hazard Disclosure Statement:

Seller and Seller's Agent(s) or a third-party consultant disclose the following information with the knowledge that even though this is not a warranty, prospective buyers may rely on this information in deciding whether and on what terms to purchase the subject property.

Seller hereby authorizes any agent(s) representing any principal(s) in this action to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

Yes____ No____

— PAGE TWO OF TWO — FORM 314 —

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____

No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.

☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither Seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by

Third-Party Disclosure Provider____ Date ___________

Date:_____________, 20______	Date:_____________, 20______
Seller: ____	Seller's Broker: ________________________DRE #__________
Seller: ____	Agent: _________________________DRE #__________

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitute all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:____ Date: _________________

Buyer:____ Date: _________________

Scan this QR-Code for a PDF of the Form!

- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or seller's agent may possess, whether contrary or supplemental to the expert's report, on the form prepared by the expert or in an addendum attached to the form; and

- **sign** the NHD Statement provided by his NHD expert and **deliver** it with the NHD report to prospective buyers or buyer's agents. [CC §1103.2(f)(2)]

When prepared by an NHD expert, the NHD report must also note whether the listed property is located within two miles of an existing or proposed airport, an environmental hazard zone called an *airport influence area* or *airport referral area*.

The buyer's occupancy of property within the influence of an airport facility may be affected by noise and restrictions, now and later, imposed on the buyer's use as set by the airport's land-use commission. [CC §1103.4(c)]

Also, the expert's report must note whether the property is located within the jurisdiction of the San Francisco Bay conservation and development commission.

Broker uses experts to limit liability

The Natural Hazard Disclosure scheme, while not making the practice mandatory, encourages brokers and their agents to use natural hazard experts rather than gather the information from the local planning department themselves. The use of an expert, who himself relies on the contents of the public record to prepare his report, **relieves** the seller's agent of any **liability for errors** not known to the agent to exist.

Neither the seller nor any agent, be he the seller's or the buyer's agent, is liable for the erroneous preparation of an NHD Statement they have delivered to the buyer, if:

- the NHD report and form is prepared by an **expert in natural hazards**, consistent with his professional licensing and expertise; and

- the seller and seller's agent used **ordinary care** in selecting the expert and in their review of the expert's report for any errors, inaccuracies and omissions of which they have **actual knowledge**. [CC §§1103.4(a), 1103.4(b)]

Neither the seller nor the seller's agent need enter into an *indemnification agreement* with the natural hazard expert to avoid liability for errors. By statute, the expert who prepared the NHD is liable for his errors, not the seller or seller's agent who relied on the report of a non-negligently selected expert to fulfill their duty to check the public records.

However, if brokers are sued based on the inaccuracy of the expert's report, an indemnity agreement entered into by the expert, given in exchange for the request to prepare a natural hazard report, will cover the cost of any litigation which might unnecessarily haul the broker into court. [See **first tuesday** Form 131]

The seller's agent's **dilatory delivery** of an expert's NHD to the buyer or the buyer's agent, after the offer has been accepted, will not protect the broker from *liability* for the buyer's lost property value due to the nondisclosure before acceptance. If the agent **knew or should have known** of a natural hazard based on the readily available planning department's parcel list, he is exposed to liability.

Liability exposure includes:

- costs the buyer may incur to correct or remedy the undisclosed hazardous condition; and

- the portion of the agreed price which exceeds the property's fair market value based on the undisclosed hazard. [CC §1103.13]

Further, the agents, seller and expert are not exposed to liability from **third parties** to the sale transaction who might receive their erroneous NHD Statement and rely on it to analyze the risk they undertake by their involvement. Such third parties include insurance companies, lenders, governmental agencies and others who may become affiliated with the transaction. [CC §1103.2(g)]

Documenting compliance with NHD law

Compliance by the seller and seller's agent to deliver the NHD Statement to the buyer is required to be documented by a provision in the purchase agreement. [CC §1103.3(b); see **first tuesday** Form 150 §11.5]

However, should the seller's agent fail to disclose a natural hazard and then provide in the purchase agreement for the compliance to be an untimely "in escrow" disclosure, his seller is **statutorily penalized**. The buyer, on an in-escrow disclosure, is allowed either a three-day right of cancellation should he be handed the NHD Statement, or a five-day right of cancellation should the NHD Statement be mailed to the buyer. [CC §1103.3(c)]

Further, delivery of the NHD after acceptance of an offer, when it could have been previously prepared by the seller or seller's agent and timely delivered, imposes liability on the seller and seller's agent, but not the buyer's agent. Liability is based on any money losses (including a reduced property value) inflicted on the buyer by the disclosure should the buyer choose not to exercise his right to cancel and instead proceed with the agreement and close escrow. [CC §1103.13; **Jue** v. **Smiser** (1994) 23 CA4th 312]

Delivery of the NHD to the buyer

It is the **buyer's agent** who has the duty to hand the buyer the NHD Statement the buyer's agent receives from the seller or the seller's agent, called *delivery*. [CC §1103.12(a)]

The **buyer's agent**, on receiving the NHD form from the seller's agent, owes the buyer a special agency duty to care for and protect his buyer's best interest by reviewing the NHD Statement himself for any disclosure which might affect the property's value or its desirability for his buyer. The buyer's agent is then required to deliver the NHD to the buyer and make any **recommendations or explanations** the buyer's agent may have regarding the consequences of its content. [CC §§1103.2, 1103.12]

If the buyer does not have a broker, the seller's agent is responsible for delivering the NHD Statement to the prospective buyer.

However, the seller's agent is not required to understand the effect hazards have on the property or the buyer. Also, the seller's agent has absolutely no duty to voluntarily explain to a prospective buyer the effect a known natural hazard (which is itself disclosed) might have on the property or the buyer. The task of explaining the consequence of living with a natural hazard is the duty of a buyer's agent.

Delivery may be in person or by mail. Also, delivery is considered to have been made if the NHD is received by the spouse of the buyer. [CC §1103.10]

Sellers occasionally act as "For Sale By Owners" (FSBOs) and directly negotiate a sale of their property with buyers in transactions which exclude brokers and agents. Here, the seller is responsible for preparing or obtaining an NHD statement and delivering the NHD Statement to the prospective buyer.

No warranty, just awareness

A seller's NHD Statement is **not a warranty or guarantee** by the seller or seller's agent of the natural hazards affecting the property. The NHD Statement is a report of the seller's and seller's agent's (or the NHD expert's) knowledge (actual and constructive) of any natural hazards affecting the property.

However, the NHD Statement is relied on by prospective buyers. The NHD is designed to assist them in their decisions as to whether they should buy the property, and if they do decide to buy, at what price and on what terms. These conditions all need to exist before entering into a purchase agreement to avoid misleading the buyer, called *deceit*. [AG Opin. 01-406]

Disclosures concerning the value and desirability of a property, such as an NHD Statement, are **price-sensitive information**. Thus, the statement must be delivered to the prospective buyer before he enters into a purchase agreement in order to accomplish their intended result. If not timely disclosed, the seller and seller's agent subject themselves to claims for **price adjustments** (offsets) which may be made by the buyer either before or after closing. Alternatively, the buyer may cancel the purchase agreement and have his deposit refunded.

Good brokerage practice would deliver the NHD to the prospective buyer before he makes an offer or accepts a counteroffer, while he is still the prospective buyer. Disclosures should not be delayed until later when the prospect has become the buyer under a purchase agreement and entitled to ownership of the property at the price and on the terms agreed. Properly, the purchase agreement offer would then include a copy of the seller's NHD Statement as an addendum (along with all other disclosures), noting the transaction is in compliance with NHD law.

As for an **escrow officer** handling a sale in which the seller's agent fails to provide the buyer's agent or the buyer with the NHD prior to opening escrow, the escrow officer has no duty to the seller or buyer to prepare, order out or deliver the NHD to the buyer. The obligation remains that of the seller and seller's agent. However, escrow may accept instruction to perform any of these activities, in which case escrow becomes obligated to follow the instructions agreed to by the escrow officer. [CC §1103.11]

Excluded sellers, not agents

While all sellers of properties must disclose what is known to them about the natural hazards endemic to a property's location, sellers in some transactions **do not need to use** the mandated NHD form to make their disclosures, such as:

- court-ordered transfers or sales;

- deed-in-lieu of foreclosures;
- trustee's sales;
- lender resales after foreclosure or a deed-in-lieu;
- estates on death;
- transfers between co-owners;
- transfers to relatives/spouses; or
- transfers to or by governmental entities. [CC §1103.1(a)]

However, any seller's agent involved in an excluded transaction must himself make hazard disclosures, even though he does not need to use the statutory form. [CC §1103.1(b)]

Also, all sellers of any type of property, included or excluded, must, as always, disclose what **they know about any hazards**. Again, the disclosure is best accomplished by use of the NHD Statement on all sales. The NHD expert will definitely include the statement as part of his report. [CC §1103.2(f)(2)]

On properties not mandated to use the form, the seller's agent can comply with his and his seller's duty to disclose by ordering a report from a natural hazard expert. On the seller's agent's receipt of the expert's report, he will review the report (preferably with the seller), add what they know about hazards which are not included in the expert's report, sign the NHD statement accompanying the report and hand the entire NHD package to prospective buyers before an offer is submitted or a counteroffer made.

Other disclosure statements distinguished

The NHD Statement handed to a prospective buyer of one-to-four unit residential property is an additional disclosure unrelated to the *environmental hazards* and *physical deficiencies* in the soil or improvements located on or about a property as disclosed on the Transfer Disclosure Statement (TDS) or in the purchase agreement. [See **first tuesday** Form 304 §C(1)]

The **TDS discloses** health risks resulting from *man-made* physical and environmental conditions affecting the use of the property. They are limited to facts known to the seller and seller's agent without concern for a review of public records on the property at the planning department or elsewhere. The **NHD Statement** discloses risks to life and property which exist *in nature* due to the property's location and are known and readily available from the public records (planning department).

Other than one-to-four

Use of the statutory NHD form for hazard disclosures by sellers and their agents is mandated only on the sale of non-exempt, targeted one-to-four unit residential property. [CC §1103]

Thus, sellers and seller's agents on all other properties do not need to use and deliver the statutory NHD form to prospective buyers of those properties. However, all sellers and their seller's agents still have a duty to disclose hazardous conditions known to them to exist.

Sellers and listing agents of **any type of real estate** must disclose whether the property is located in:

- an area of potential flooding;
- a very high fire hazard severity zone;
- a state fire responsibility area;
- an earthquake fault zone; and
- a seismic hazard zone. [CC §1103.2]

Even though use of the form is not mandated for sales of property other than one-to-four residential units, agents best meet their hazard disclosure duty in all transactions by using the NHD Statement to convey their knowledge and information contained in public records. [CC §1103.1(b)]

Editor's note — The following discussion details the different hazards which must be disclosed on the NHD Statement.

Flood zones

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act of 1968 (NFIA).

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP).

The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a *special flood hazard area* and must be disclosed as a natural hazard on the NHD Statement. [See Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Information about flood hazard areas and zones can come from:

- city/county planners and engineers;
- county flood control offices;
- local or regional FEMA offices; and
- the U.S. Corps of Engineers.

Additional information concerning flood hazard areas can be obtained in the Community Status Book. The book lists communities and counties participating in the NFIP and the effective dates of the current flood hazard maps available from FEMA.

The Community Status Book can be obtained via the web at: http://www.fema.gov/fema/csb.shtm.

Flood Insurance Rate Maps and Flood Hazard Boundary Maps are all available at the FEMA Flood Map store by calling (800) 358-9616 or via the web at: http://msc.fema.gov/.

Another flooding disclosure which must be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See Form 314 §2]

An area of potential flooding is a location subject to partial flooding if sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Office of Emergency Services. [Calif. Government Code §8589.5(a)]

Once alerted by the listing agent to the existence of a flooding condition, the buyer's agent must inquire further to learn the significance of the disclosure to the buyer.

Very high fire hazard severity zone

Areas in the state which are subject to significant fire hazards have been identified as *very high fire hazard severity zones*. If a property is located in a very high fire hazard severity zone, a disclosure must be made to the prospective buyer. [See Form 314 §3]

The city, county or district responsible for providing fire protection have designated, by ordinance, very high fire hazard severity zones within their jurisdiction. [Gov C §51179]

The fire hazard disclosure on the NHD form mentions the need to maintain the property. Neither the seller nor the seller's agent need to explain the nature of the maintenance required or its burden on ownership. Advice to the buyer on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the buyer's agent, if they have an agent.

For example, a buyer occupying a residence located in a very high fire hazard severity zone is advised by his agent that as the new owner, the buyer must, among other things:

- maintain a firebreak around the structure of a distance of no greater than 100 feet, but not past the property line, unless the state or local law requires more; and

- clear dead or dying wood from trees and plants adjacent to or overhanging the structure. [Gov C §51182]

Also, if the property is in a very high fire hazard severity zone or a wildland area, the buyer's agent should inform his client of the possible hardships in obtaining fire or hazard insurance and of the existence of the California Fair Access to Insurance Requirements (FAIR) program which offers a "last-resort" type of policy for properties in these areas. [Calif. Insurance Code §§10095 et seq.]

State Fire Responsibility Areas

If a property is in an area where the financial responsibility for preventing or suppressing fires is primarily on the state, the real estate is located within a *State Fire Responsibility Area*. [Calif. Public Resources Code §4125(a)]

Notices identifying the location of the map designating State Fire Responsibility Areas are posted at the offices of the county recorder, county assessor and the county planning agency. Also, any information received by the county after receipt of a map changing the State Fire Responsibility Areas in the county must be posted. [Pub Res C §4125(c)]

If the property is located within a **wildland area** exposed to substantial forest fire risks, the seller or his agent must disclose this fact. If the property is located in a wildland area, it requires maintenance by the owner to prevent fires. [Pub Res C §4136(a); see Form 314 §4]

In addition, the NHD Statement advises the prospective buyer of a home located in a **wildland area** that the **state has no responsibility** for providing fire protection services to the property, unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency. No further disclosure about whether a cooperating agreement exists need be made by the seller or seller's agent. [See Form 314 §4]

However, if property disclosures place the property in a wildland area, the buyer's agent has the duty to advise the buyer about the need to inquire and investigate into what agency provides fire protection to the property.

Earthquake fault zones

To assist seller's agents in identifying whether the listed property is located in an earthquake fault area, maps have been prepared by the State Geologist.

The State Mining and Geology Board and the city or county planning department have maps available which identify special studies zones, called *Alquist-Priolo Maps*. [Pub Res C §2622]

The maps are used to identify whether the listed property is located within one-eighth of a mile on either side of a fault.

Also, the NHD Statement requires both the seller and the seller's agent to disclose to a prospective buyer or the buyer's agent whether they have knowledge the property is in a fault zone. [See Form 314 §5]

Seismic hazards

A *Seismic Hazard Zone* map identifies areas which are exposed to earthquake hazards, such as:

- strong ground shaking;
- ground failure, such as liquefaction or landslides [Pub Res C §2692(a)];
- tsunamis [Pub Res C §2692.1]; and
- dam failures. [Pub Res C §2692(c)]

If the property for sale is susceptible to any of the earthquake (seismic) hazards, the seismic hazard zone disclosure on the NHD Statement must be marked "Yes." [See Form 314 §6]

Seismic hazard maps are not available for all areas of California. Also, seismic hazard maps do not show **Alquist-Priolo** Earthquake Fault Zones. The California Department of Conservation creates the seismic hazards maps.

The seismic hazard maps which exist are on the web at http://www.conservation.ca.gov/cgs/shzp/Pages/Index.aspx.

If the NHD indicates a seismic hazard, the buyer's agent must then determine which type of hazard, the level of that hazard and explain the distinction to the buyer, or see to it that someone else does. The seller's agent has no such obligation to the buyer.

For example, property located in Seismic Zone 4 is more susceptible to strong ground shaking than areas in Zone 3. But which zone the property is located in is a question the buyer's agent must answer. Most of California is in Zone 4, except for the southwest areas of San Diego County, eastern Riverside and San Bernardino Counties, and most of the Northern California Sierra Counties.

Homes in Zone 4 can be damaged even from earthquakes which occur a great distance away.

Ground failure is a seismic hazard which refers to landslides and liquefaction. Liquefaction occurs when loose, wet, sandy soil loses its strength during ground shaking. Liquefaction causes the foundation of the house to sink or become displaced. The condition is prevalent in tidal basins which are fills.

A **tsunami** is a large wave caused by an earthquake, volcanic eruption or an underwater landslide. Coastal areas are the ones at risk for loss of property and life.

Tsunami inundation maps are available from the National Oceanic and Atmospheric Administration (NOAA) led National Tsunami Hazard Mitigation Program (NTHMP) at: *http://nctr.pmel.noaa.gov/inundation_mapping.html.*

Also, FEMA's Flood Insurance maps consider tsunami wave heights for Pacific coast areas.

Dam failure results in flooding when an earthquake causes a dam which serves as a reservoir to rupture. The city or county planning department has maps showing areas which will be flooded if a local dam fails.

Areas susceptible to inundation due to dam failure caused by an earthquake are also noted on the NHD Statement as a potential flooding area.

Chapter 21 Structural pest control reports and repairs

This chapter digests the requirements, delivery and repercussions of the Structural Pest Control Report.

For a further discussion of this topic, see Chapter 29 of Real Estate Practice.

Chapter 21 Terms

Accessible area	*Prospective buyer*
Certificate of clearance	*Structural Pest Control Report*
Due diligence checklist	*Undisclosed facts known or readily available*
Inaccessible area	

Eliminate the risk

Unlike a Transfer Disclosure Statement (TDS) or a Natural Hazard Disclosure (NHD), a *structural pest control (SPC) Report* is not a required disclosure in a California real estate transaction. Most conventional lenders will not require a report or clearance.

Since 2005 the FHA has not required automatic **SPC** inspections, reports and clearances for every home sale involving an FHA-insured mortgage. In an effort to further U.S. homeownership, the requirements for obtaining maximum purchase-assist financing insured by the FHA now r**equires an inspection** only if:

- it is customary for home sales in the area;
- an active infestation is observed on the property;
- it is mandated by state or local law; or
- it is called for by the lender. [Mortgagee Letter 05-48]

However, prudent buyers and buyer's agents, also known as *selling agents*, alert to the fact they are duty-bound to act in the best interests of their buyers will demand an SPC inspection,

report, and certification by placing a straightforward, simple **SPC contingency provision** in the purchase agreement, regardless of the nature of the buyer's purchase-assist financing. [See **first tuesday** Form 150 §11.1(a)]

Seller's agents acting in the best interest of their sellers will urge their sellers to authorize a prompt inspection and report upon taking the listing. The report, or better yet the clearance after all recommended repairs are completed, will be included in the seller's agent's marketing package.

Disclosure up front and before accepting offers promotes the profession's need for transparency in a transaction. Transparency avoids personal liability for withholding information known to the seller or the seller's agent from prospective buyers about a material fact, conduct called **deceit**.

When to deliver the SPC report

The existence of termites **adversely affects** the value of property, which is why disclosure is compelled before the buyer enters into a purchase contract and sets the price and closing conditions with the seller.

In a transparent real estate market, the report and clearance would be part of the **marketing package** given to any prospective buyer who seeks more information on the property. A request for further information by a prospective buyer constitutes the commencement of negotiations toward the purchase of a property.

Purchase agreements frequently include SPC provisions in the terms of purchase or as a condition of financing. When a purchase agreement requires an SPC report, a copy of the SPC report must be **delivered to the prospective buyer** or buyer's agent by the seller or his agent **as soon as practicable** (ASAP). ASAP means prior to entering into the purchase agreement if the SPC report is available.

However, if for lack of a report it is not possible to hand the prospective buyer the SPC report until after the seller's acceptance of the purchase offer, closing is automatically contingent on the buyer's right to cancel the purchase agreement and escrow instructions. [Calif. Civil Code §1099(a)]

The term "as soon as practicable" actually carries the same meaning as does the term "as soon as possible". Thus, ASAP means an existing termite report will be delivered to the *prospective buyer* when the seller's agent involved become aware the buyer is going to submit an offer calling for an SPC report or for financing which requires an SPC report.

Should the offer be submitted to the seller without prior indication to the seller's agent that the buyer or the lender will require an SPC report, a counteroffer should be made. The counteroffer would deliver the SPC report, and if not available, advise the buyer of the termite information known to the seller or the seller's agent. [Calif. Attorney General Opinion 01-406 (August 24, 2001)]

A counteroffer could be used solely for the purpose of making the SPC disclosure, even if no need exists for a change in the terms of the buyer's offer. Disclosure is always most **practicable** before the acceptance occurs—ASAP—to determine if the buyer's knowledge of the contents of a report or other knowledge of the termite conditions causes the buyer to reconsider the price or terms of his offer.

The **failure to disclose** before the seller accepts the buyer's offer is the result of one of two situations:

1. No one knows about the existence of termites or the damage they created because the readily available inspection and report was not ordered and the discovery was not made before the property was put under contract with the buyer.

2. The seller or the seller's agent resorts to deceit as the existence of a condition which adversely affects value is known to the seller or the seller's agent and not disclosed before the seller accepts the buyer's purchase offer.

The second situation is fraudulent and allows the buyer to pursue the seller and the seller's broker/agent to recover the **cost of repairs**. Contract provisions in the purchase agreement allowing the seller to entirely avoid the cost of termite clearance and repairs are not enforceable when known defects go undisclosed at the time the buyer goes under contract. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A separated SPC report

The custom brought about by the bifurcated pest control handling through an addendum to purchase agreements supplied by the trade associations causes agents to request the SPC company to prepare a **separated report**. The SPC company is asked to separate their findings and recommendations into two categories:

- **Section I items**, listing items with visible evidence of active infestations, infections, or conditions that have resulted in or from infestation or infection; and

- **Section II items**, listing conditions deemed likely to lead to infestation or infection but where no visible evidence of infestation or infection was found.

However, sellers need to order the inspection and report when the property is listed so any necessary repairs will become known, the cost for any correction ascertained, and any repairs completed before a prospective buyer is located. Misrepresentations of the property's condition cannot then become surprises during escrow. On the other hand, it is the intention of some sellers to contract for the buyer to be responsible for the structural pest control clearance, a situation which easily leads to nondisclosure.

These "defective" conditions of termites and their damage to the property are owned by the seller. In a bust market, the buyer with a buyer's agent whose duty of care it is to protect his buyer is not about to let the seller pass any sort of deficiency which adversely affects the value of the property onto the buyer.

Thus, requesting a separated report in the current climate is misdirected since the intent of a separated report is to divide the type of conditions and, more importantly, to shift the responsibility which is the seller's alone to an unsuspecting buyer.

More to the point, why risk having prospective buyers walk away from your listing, especially in a buyer's market, just because a termite-free home with a clearance and certainty of risk is available around the corner to the risk-averse buyer?

A certificate of clearance

An active termite infestation or fungus infection is occasionally found on an inspection prior to marketing the property. The seller then needs to consider taking corrective measures to both protect the property from further damage and ready it for a prospective buyer by eliminating the issue of termites.

A **Pest Control Certification**, a statement by the SPC company indicating the property is free of infestation or infection in the visible and accessible areas, will then be issued. This certification is commonly called a termite clearance. However, if any signs of infestation or infection **have not been corrected**, it will be noted in the certification. [Calif. Business and Professions Code §8519]

The FHA when insuring a loan only requires a certificate of clearance stating that Section 1 items have been corrected. However, any Section 2 conditions which may lead to future infestations or infections will be noted on the Pest Control Clearance so the SPC company will not be liable for the costs incurred to eliminate those conditions. Section II conditions usually are only observed in homes that do not have a slab foundation and have a crawl space beneath the floor of the structure. [Bus & P C §§8516(d), 8519]

The original inspection and report

The individual or company who does the inspection and issues the report must hold a Branch 3 Wood-Destroying Pest and Organisms License/Registration. Only those with a **Branch 3 license** may:

- **perform inspections** for wood-destroying pests and organisms;
- **issue inspection reports** and completion notices;
- **conduct treatments**; and
- **perform any repairs** recommended on the inspection report.

An inspection will cover all *accessible areas* to determine whether an active infestation or infection exists or if conditions which will likely lead to future infestations or infections exists. *Inaccessible areas* do not need to be covered in an inspection.

An area is considered **inaccessible** if it cannot be inspected without opening the structure or removing the objects blocking the opening. Examples of inaccessible areas are:

- attics or areas without adequate crawl space;
- slab foundations without openings to bathroom plumbing;
- floors covered by carpeting;
- wall interiors; and
- locked storage areas.

All SPC companies use a **standardized inspection report** form. An inspection report includes:

- the inspection date and the name of the licensee making the inspection;
- the name and address of the person ordering the report;
- the name and address of any party in interest;
- the address or location of the property;
- a general description of the building or premises inspected;
- a diagram detailing every part of the property checked for infestation or infections;
- a notation on the diagram of the location of any wood-destroying pests (termites, wood-boring beetles, etc.) or fungus present, and any resulting structural damage visible and accessible on the date of inspection, called **Section I items** if a separated report is requested;
- a notation on the diagram of the location of any conditions (excessive moisture, earth-to-wood contact, faulty grade levels, etc.) considered likely to lead to future wood-destroying pest infestations or infections, called **Section II items** if a separated report is requested;
- one of the following statements:
    - **“The exterior surface of the roof was not inspected. If you want the water tightness of the roof determined, you should contact a roofing contractor who is licensed by the Contractors’ State License Board.”**
    - **“The exterior surface of the roof was inspected to determine whether or not wood destroying pests or organisms are present.”**
- a statement of which areas have not been inspected due to inaccessibility with recommendations for further inspection of these areas if practicable;
- recommendations for treatment or repair;

- information regarding the pesticide(s) to be used, if necessary;
- that a reinspection will be performed if an estimate for making repairs is requested by the person ordering the original report; and
- the following bold-type statement:
    - **"NOTICE: Reports on this structure prepared by various registered companies should list the same findings (i.e., termite infestations, termite damage, fungus damage, etc.). However, recommendations to correct these findings may vary from company to company. You have a right to seek a second opinion from another company."** [Bus & P C §8516(b); 16 Calif. Code of Regulations §1990]

Further, the following statement must appear prior to the first finding/recommendation on a separated report:

- "This is a separated report which is defined as Section I/Section II conditions evident on the date of the inspection. Section I contains items where there is visible evidence of active infestation, infection or conditions that have resulted in or from infestation or infection. Section II items are conditions deemed likely to lead to infestation or infection but where no visible evidence of such was found. Further inspection items are defined as recommendations to inspect area(s) which during the original inspection did not allow the inspector access to complete the inspection and cannot be defined as Section I or Section II."

The company chosen must furnish the person who ordered the inspection a copy of the report within 10 business days of the inspection. [Bus & P C §8516(b)]

All original inspection reports must be maintained by the SPC company for three years. [Bus & P C §8516(b)]

All SPC companies must post an **inspection** tag in the attic, subarea, or garage on completion of an inspection. The tag must give the company's name and the date of inspection. [16 CCR §1996.1]

Chapter 22 Environmental hazards and annoyances

This chapter presents the environmental conditions located on or in the vicinity of a property which adversely affect occupants of the property due to their injurious effect on the health or sensitivity of humans.

For a further discussion of this topic, see Chapter 30 of Real Estate Practice.

Chapter 22 Outline

Noxious man-made hazards
Property conditions affecting desirability, as disclosed
Delivery of the TDS
The buyer's agent's review as his risk mitigation
Need and motivation for disclosure

Chapter 22 Terms

Airport influence area	*Industrial Zoning*
Asbestos	*Lead*
Carcinogen	*Material fact*
Environmental hazard	*Military ordinance site*
Fibrous mineral silicate	*Radon gas*
Formaldehyde	*Security bars*
Friable asbestos	*Smoke*
Ground transportation artery	*Toxic Mold*
Hazardous waste	*Visual Inspection*

Noxious man-made hazards

Environmental hazards are noxious or annoying conditions which are **man-made hazards**, not natural hazards. As **environmental hazards**, the conditions are classified as either:

- **injurious** to the health of humans; or
- an **interference** with an individual's sensitivities.

In further analysis, environmental hazards are either located on the property or originate from sources located elsewhere which affect the occupant in his **use and enjoyment** of the property.

Environmental hazards **located on the property** which pose a direct health threat on occupants due to construction materials, the design of the construction, the soil or its location, include:

- *asbestos-containing* building materials and products used for insulation, fire protection and the strengthening of materials [Calif. Health and Safety Code §§25915 et seq.];

- *formaldehyde* used in the composition of construction materials [Calif. Civil Code §2079.7(a); Calif. Business and Professions Code §10084.1];

- *radon gas* concentrations in enclosed, unventilated spaces located within a building where the underlying rock contains uranium [CC §2079.7(a); Bus & P C §10084.1];

- *hazardous waste* from materials, products or substances which are **toxic**, **corrosive**, **ignitable** or **reactive** [Health & S C §25359.7; Bus & P C §10084.1];

- *toxic mold* [Health & S C §§26140, 26147];

- *smoke* from the combustion of materials, products, supplies or substances located on or within the building [Health & S C §§13113.7, 13113.8];

- *security bars* which might interfere with an occupant's ability to exit a room in order to avoid another hazard, such as a fire [CC §1102.16; Health & S C §13113.9]; and

- *lead*. [See Chapter 23]

Environmental hazards **located off the property**, but which have an adverse effect on the use of the property due to noise, vibrations, odors or some other ability to inflict harm, include:

- *military ordnance* sites within one mile of the property [CC §1102.15];

- *industrial zoning* in the neighborhood of the property [CC §1102.17];

- *airport influence* areas established by local airport land commissions [CC §§1103.4(c), 1353; Bus & P C §11010(b)(13)]; and

- *ground transportation* arteries which include train tracks and major highways in close proximity to the property.

Property conditions affecting desirability, as disclosed

In most circumstances, the existence of an **environmental hazard** has an adverse impact on the desirability and value of any property marketed for sale. Accordingly, seller's agents are mandated to disclose environmental hazards on the listed property that are observed and known (or should have been known) to the seller or seller's agent.

If they exist, environmental hazards are a *material fact* requiring upfront disclosure by the seller's agent. After all, the **facts** might affect an interested buyer's decision to submit an offer to purchase the property, and on what terms, such as who is to do what about the hazards.

Further, for a disclosure of facts affecting a property's value to be meaningful, the buyer must receive them before his offer is prepared, submitted and accepted. Ultimately, property is purchased on conditions **known** and capable of disclosure upfront, not on disclosures delayed until the property is under contract.

The disclosure by a seller and the seller's agent of their personal knowledge of **existing** environmental hazards on a one-to-four unit single family residence (SFR) is mandated on the sale, exchange or lease of all types of property.

Environmental hazards are disclosed by the seller and the seller's agent in the *Condition of Property Disclosure – Transfer Disclosure Statement (TDS)* under the "Seller's Information" category at Section C. As a further explanation, the *Residential Environmental Hazards: A Guide for Homeowners, Homebuyers, Landlords and Tenants* reviews common environmental hazards which **may exist** on any property. [CC §2079.7; see **first tuesday** Form 316-1]

The explanatory **Residential Environmental Hazards: A Guide for Homeowners, Homebuyers, Landlords and Tenants** publication is not a disclosure of detrimental environmental conditions which actually exist on a property. Rather, the booklet contains **general information** on a variety of environmental hazards, none of which might physically exist on the subject property. The guide is voluntarily delivered to the buyer by the seller's agent, but with no legal mandate to do so. [CC §2079.7(b); see **first tuesday** Form 316-1]

The Residential Environmental Hazards Guide is published by the California Environmental Protection Agency. The guide is designed to educate and inform buyers about potential environmental hazards which may be found on or about a residential property, such as:

- asbestos;
- carbon monoxide;
- formaldehyde;
- fuel and chemical storage tanks;
- hazardous waste,
- lead;
- mold; and
- radon. [Calif. Bus & P C §10084.1(a)(1)]

Included in the guide is a discussion about the significance of hazardous materials and conditions, and tips for identifying, locating and mitigating the hazards. Also discussed are the symptoms experienced by humans that result from the hazards. The Residential Environmental Hazards Guide was updated in 2011 to feature additional resources and publication lists for further study by the buyer. [Calif. Bus & P C §10084.1; see **first tuesday** Form 316-1]

Delivery with the TDS

The optional delivery of the Residential Environmental Hazards Guide is not to be confused with the mandatory delivery of a completed TDS on one-to-four unit SFRs. Good practice suggests the hazard guide is delivered with the TDS to those buyers expressing interest in buying a property. [See **first tuesday** Form 304]

The seller's agent on the sale of a one-to-four unit SFR is obligated to personally conduct a *visual inspection* of the listed property for environmental hazards (as well as physical defects). This obligation remains even when a *home inspection report* is obtained or the seller is exempt from using a TDS form to disclose the hazards and defects known to them.

The seller's agent's findings on his inspection are documented on the TDS initially prepared by the seller, then timely delivered to the buyer upfront. Delivery of the TDS to prospective buyers advises them of the seller's agent's observations during his visual inspection of the property and any personal knowledge he may otherwise have about conditions on the property, as well as the seller's, which constitute environmental hazards. [CC §2079; see **first tuesday** Form 304]

Further, the time for delivery of the mandatory TDS to a prospective SFR buyer is of critical importance for *risk mitigation management* by the seller and the seller's agent. Delivery before an offer is accepted avoids demands on the seller and the seller's broker for their elimination of the environmental (and physical) defects known to them, but not the buyer, at the moment the buyer's offer is accepted.

As known to all, acceptance is the act which forms a **binding contract** between the seller and the buyer and is the moment that sets the buyer's expectations about the property conditions. If the buyer knew everything about the property that the seller and his agent know, would he be buying this property at the price and on the terms offered? Ask yourself if your deals clear this hurdle of transparency in symmetry which is always applied by the courts.

Upfront delivery to prospective buyers, before an offer is submitted and a **purchase agreement** is entered into, conforms to the legislative intent regarding the timing for the mandatory disclosure of existing environmental hazards (and physical conditions) itemized in the TDS. [Attorney General Opinion 01-406 (August 24, 2001); CC §1103.3(a)(2)]

Since the Residential Environmental Hazards Guide discusses all environmental hazards which may potentially be present in or about the property, including existing hazards disclosed in the TDS, the Guide is functionally best delivered to prospective buyers with the TDS.

Delivery of the booklet in conjunction with the TDS and its factual disclosures concludes the seller's agent's disclosure of **environmental hazards** and eliminates any further duty he has to advise the prospective buyer about the existence of environmental hazards. [CC §2079.8]

Thus, if a hazardous condition disclosed in the TDS is addressed in the booklet, the disclosure of the condition in the TDS together with the booklet covers the extent to which the seller's agent must go to provide a full disclosure about the existence and nature of that hazardous condition.

For the purposes of the seller's side of the transaction, the agent and seller need to say nothing more to the buyer beyond timely providing him the TDS and the booklet to make the disclosures, unless the buyer inquires further which requires an honest and complete response.

While the timely disclosure of an **environmental hazard** is the obligation of the seller, it is the seller's agent who has the **agency duty** of care and protection owed to his seller to see to it the seller is in compliance with the environmental hazard disclosure requirements.

The buyer's agent's review as his risk mitigation

If the seller or seller's agent have not provided the buyer with the hazards booklet, the buyer's agent may deliver it to the buyer himself, the preparation and delivery of the TDS being the exclusive domain of the seller, and in turn the seller's agent.

While the seller's agent is required to provide the buyer with the mandatory TDS, the seller's agent has **no duty to discuss** the effect of the hazards with the buyer after the documents have been delivered, unless the buyer inquires.

The buyer's agent reviews the booklet's explanation of the disclosed hazards with the buyer and notes the consequences of the hazards.

On delivery of the TDS by the seller's agent, it becomes the duty of the buyer's agent to point out the hazards disclosed. He then **reviews** the booklet's explanation of the disclosed hazards with the buyer, noting the consequences of the hazards and counseling the buyer on the alternatives available to mitigate the hazards should he make an offer to acquire the property.

Simply handing the buyer and booklet without directing attention to the specific contents of the booklet that directly relates to the hazard located on the subject property is insufficient: doing so is as feckless as merely handing the buyer the so-generic-as-to-be-useless *Statewide Buyer and Seller Advisory* published by the trade union.

Further, the buyer's agent's discussion about environmental hazards with the buyer provides the buyer with information necessary for setting the price and terms of any offer the buyer will make to acquire the property.

Need and motivation for disclosure

For the seller's agent to properly anticipate the need to have the disclosures available to deliver to prospective buyers, the effort to promptly gather the information from the seller begins at the moment the listing is solicited and negotiated.

The seller and the seller's agent have numerous good reasons to fully comply at the **earliest moment** with the environmental hazard disclosures (as well as all other property-related disclosures). The **benefits of a full disclosure**, up front and before the seller accepts an offer or makes a counteroffer, include:

- the prevention of delays in closing;

- the avoidance of cancellations on discovery under due diligence investigation contingencies;
- the elimination of having to renegotiate the price or offset corrective costs due to the listing agent's dilatory disclosure or the buyer's discovery during escrow;
- the shortening of the time needed for the buyer to complete his due diligence investigation; and
- control by the seller of remedial costs and responsibilities by terms included in the purchase agreement, not by later offsets or demands by the buyer or a court.

The seller's agent needs to document in writing (for his file only) the agent's inquiry of the seller about environmental hazards which are known or should be known to the seller. The agent's list should itemize:

- all the environmental hazards which might possibly exist on or about a property and the construction materials which contain them;
- the age or date of construction to elicit a review of probable hazardous construction materials used at the time of construction; and
- information known about the property on disclosures the seller received when he purchased the property or were brought to his attention on any renovation of the property.

Also, the listing agent's inquiry into hazardous materials should precede the seller's preparation of the TDS. Thus, the seller is mentally prepared to release information about his knowledge of defects in the condition of the property. Finally, the listing agent's visual inspection should also be conducted before the seller prepares his TDS so his observations may be discussed.

The seller has **no obligation to hire an expert** to investigate and report on whether an environmental hazard is present on or about the property. The seller is also not obligated to remove, eliminate or mitigate an environmental hazard, unless he becomes obligated under the terms of his purchase agreement with the buyer.

It is the seller's and his listing agent's knowledge about the property which is disclosed on the TDS.

The off-site environmental hazards which affect the use of the property are generally well known by the buyer's agent for inclusion in the purchase agreement. If not included in the TDS or the purchase agreement, a counteroffer by the seller is necessary to disclose — as soon as practicable — the seller's and the listing agent's knowledge of environmental hazards located both on and off the property.

Chapter 23 Lead-based paint disclosures

This chapter evaluates the lead-based paint hazard disclosure mandatory on the sale of all residential housing built prior to 1978 and the risks of accepting a buyer's purchase agreement offer before disclosure.

For a further discussion of this topic, see Chapter 31 of Real Estate Practice.

Chapter 23 Outline

Crystal clear transparency
Lead-based paint and hazards
LBP disclosure content
Foreclosure sale exemption

Chapter 23 Terms

Transfer Disclosure Statement
Federal Lead-based Paint Disclosure
Lead-based paint
Lead-based paint hazard
Lead Warning Statement
Listing package
Real estate owned property

Crystal clear transparency

An agent, while soliciting an owner of a residential property to employ the agent's broker to market and locate a buyer for the property, gathers facts about the property, its ownership and its likely market value.

The property profile furnished by a title company confirms the agent's suspicion that the structure was built **prior to 1978**. The agent is now aware the property is the target of separate state and federal environmental protection disclosure programs designed to prevent the poisoning of children by the presence of lead-based paint.

The agent sets up a meeting with the owner to review the requisite listing and marketing requirements laid down by his broker, and the owner's expectations for a listing price and an acceptable sales price. To prepare for the meeting, the agent fills out the listing agreement and attaches all the disclosure forms needed to correctly market and sell the property, called a *listing package*.

Among other informational forms, the agent includes two forms which address **lead-based paint conditions** on the property:

- the *Federal Lead-based Paint (LBP) disclosure* [See **first tuesday** Form 313]; and
- the California *Transfer Disclosure Statement (TDS)*. [See **first tuesday** Form 304]

At the presentation of the listing agreement, the agent explains the **seller's legal obligation**, owed to prospective buyers and their agents, to provide them with all the information known to the owner or readily available on an inquiry by the seller's agent, also known as the *listing agent*, which might adversely affect the property and its value.

By making the transaction **fully transparent** to prospective buyers from the outset of negotiations, the renegotiation of the purchase agreement, including a demand for a price reduction, cancellation or refund after closing due to further disclosures, is avoided. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A full disclosure to the prospective buyer about the property by the seller and the seller's agent does not entail a review or explanation of the facts disclosed. Application of the facts disclosed and the potential consequences flowing from the facts which may affect the prospective buyer's use, possession or ownership of the property are not among the listing agent's duties of affirmative disclosure.

However, federal LBP rules do require the seller's agent to advise the seller of his pre-purchase agreement disclosure requirements. The seller's agent must **insure compliance** by or on behalf of the seller before entering into a purchase agreement.

Editor's note — Regarding the LBP disclosures, the owner is properly informed he has no obligation to have his property inspected and have a report prepared on the presence of lead-based paint or any lead-based paint hazards. Also, the owner is advised he does not have to perform any ***corrective work*** *to clean up or even eliminate the conditions, unless he agrees with the buyer to do so. [24 Code of Federal Regulations §35.88(a); 40 CFR §745.107(a)]*

Thus, the seller needs to cooperate in the LBP disclosure and his agent's marketing efforts by:

- filling out and signing the federal LBP disclosure form required on all pre-1978 residential construction [See **first tuesday** Form 313];
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions [See **first tuesday** Form 304];
- making a physical home inspection report available to prospective buyers as an attachment to the TDS form; and
- providing the seller's agent with copies of any reports or documents containing information about lead-based paint or lead-based paint hazards on the property.

Lead-based paint and hazards

Lead-based paint, defined as any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight, was **banned** by the Federal Consumer Product Safety Commission in 1978. [24 CFR §35.86; 40 CFR §745.103]

A *lead-based paint hazard* is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [24 CFR §35.86; 40 CFR §745.103]

Editor's note — A list of statewide laboratories certified for analyzing lead in hazardous material, including paint, is available from the National Lead Information Center at (800) 424-LEAD. Lists are also available on the web at http://www.leadlisting.com/lead.html and http://www.dhs.ca.gov/childlead.

LBP disclosure content

The **LBP disclosure** form includes the following:

- the *Lead Warning Statement* as written in federal regulations [See **first tuesday** Form 313 §1];

- the seller's statement **disclosing the presence** of known lead-based paint hazards or the seller's lack of any knowledge of existing lead-based paint [See **first tuesday** Form 313 §2];

- a **list of records or reports** available to the seller which indicates a presence or lack of lead-based paint, which have been handed to the seller's agent [See Form **first tuesday** 313 §2.2];

- the buyer's statement **acknowledging receipt** of the LBP disclosure, any other information available to the seller and the lead hazard information pamphlet entitled **Protect Your Family From Lead in Your Home** [See Form **first tuesday** 313 §3.1; see **first tuesday** Form 316-1];

- the buyer's statement acknowledging the buyer has received a 10-day **opportunity to inspect** the property or has agreed to reduce or waive the inspection period [See Form **first tuesday** 313 §3.2];

- the listing agent's statement noting the seller has been informed of the seller's disclosure requirements and that the agent is aware of his **duty to ensure** the seller complies with the requirements [See **first tuesday** Form 313 §4]; and

- the **signatures** of the seller, buyer and listing agent. [24 CFR §35.92(a)(7); 40 CFR §745.113(a)(7)]

The seller and the seller's broker must each keep a copy of the disclosure statement for at least three years from the date the sale is completed. [24 CFR §35.92(c); 40 CFR §745.113(c)]

Whether or not the LBP disclosure form is retained does not have an effect on the statute of limitations for the buyer to pursue misrepresentations or alter the buyer's right to post-contract disclosures. [24 CFR §35.92(c)(2); 40 CFR §745.113(c)(2)]

Also, the disclosure form must be in the language of the purchase agreement. For example, if the purchase agreement is in Spanish, then the LBP disclosure must also be in Spanish. [24 CFR §35.92(a); 40 CFR §745.113(a)]

Foreclosure sale exemption

Exempt from the Federal LBP disclosures are foreclosure sales of residential property. [24 CFR §35.82(a)]

Yet, a foreclosing lender still has a common law duty to disclose known defects at the foreclosure sale.

Thus, even if the property is purportedly sold "as-is" at a foreclosure sale, a foreclosing lender is not protected from liability for intentional misrepresentation (negative fraud by omission) and deceit should the foreclosing lender have knowledge of a defect in the property and fail to disclose the defect at the time of the sale to the highest bidder. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

However, the foreclosure exemption does not apply to the resale of housing previously acquired by the lender at a foreclosure sale, commonly called real estate owned (REO) property, or to the resale by a third party bidder who acquired the property at a foreclosure sale.

Thus, if a lender or other bidder who acquired property at a foreclosure sale is reselling it, the resale must comply with the lead-based paint disclosure requirements. [61 Federal Register 9063]

Chapter 24 Prior occupant's use, affliction and death

This chapter applies the disclosure of a prior occupant's death or affliction with AIDS.

For a further discussion of this topic, see Chapter 34 of Real Estate Practice.

Chapter 24 Outline

When and when not to disclose
Disclosure on inquiry
Deaths affecting market value

Chapter 24 Terms

Affirmative duty	*General duty*
Agency duty	*Material fact*

When and when not to disclose

A real estate broker and the seller's agent, also referred to as the *listing agent,* are employed by a seller to locate a buyer for his real estate. The seller's agent soon locates a buyer who wants to purchase the property.

Prior to making an offer, the seller's agent hands the buyer the seller's *Transfer Disclosure Statement (TDS)* disclosing the seller's and agent's knowledge about the present **physical condition** of the property. All other mandatory disclosures are made. [See **first tuesday** Form 304]

The buyer does not inquire into any deaths which might have occurred on the property. Ultimately, the buyer acquires and occupies the property.

Later, the buyer is informed a prior occupant died on the property from AIDS or HIV. This death occurred **more than three years** before the buyer submitted the offer to purchase the property.

The buyer discovers the seller's agent knew of the prior occupant's AIDS affliction and death on the property. The buyer claims the seller's agent breached his agency duties by failing to voluntarily disclose this information to the buyer.

Here, a real estate agent has no *affirmative duty* to **voluntarily disclose** information to a potential buyer regarding a prior occupant:

- whose *death*, from any cause, occurred on the real estate **more than three years prior** to the purchase offer; or
- who was *afflicted* with the HIV virus or afflicted with **AIDS**. [Calif. Civil Code §1710.2(a)]

Editor's note — Deaths on the property which occurred ***within three years*** *of the offer are treated differently.*

Disclosure on inquiry

Consider a buyer who asks the seller's agent if any deaths have ever occurred on the property.

On **direct inquiry** by the buyer or his agent, the seller's agent must **disclose his knowledge** of any deaths on the real estate, no matter when they occurred. [CC §1710.2(d)]

An intentional misrepresentation or concealment by any agent in the real estate transaction after a buyer makes a *direct inquiry* is:

- a breach of the listing agent's *general duty* owed to the buyer to truthfully respond when the seller's agent represents the seller exclusively; or
- a breach of the buyer's agent's *agency duty* owed the buyer since the agent is the buyer's representative in the transaction. [CC §1710.2(d)]

Further, an **inquiry** by the buyer into deaths indicates that a death on the premises is a fact which might affect the buyer's use and enjoyment of the property, a *material fact*. Thus, an affirmative duty is imposed on the **buyer's agent** to either investigate or recommend an investigation by the buyer before an offer is made, unless the offer includes a contingency on the subject of death.

An agent who discloses, on inquiry, that he does not know if a death occurred on the real estate, or has limited information which he does disclose, should hand the buyer a memorandum stating:

- the buyer has made an inquiry about deaths on the property;
- the agent has disclosed all his knowledge concerning the inquiry; and
- whether the agent will further investigate any deaths on the property.

Deaths affecting market value

An agent's duty to disclose facts known to them which may adversely affect the property's value, called *material facts*, is not limited to disclosures of the property's physical condition.

Every agent has an affirmative duty to disclose prior deaths when the death **might affect the buyer's valuation** or desire to own the property. [**Reed** v. **King** (1983) 145 CA3d 261]

Chapter 25 Marketing condominium units

This chapter explores the seller's agent's use of condominium association documents to market a unit listed for sale and to inform prospective buyers about the association and the project.

For a further discussion of this topic, see Chapter 32 of Real Estate Practice.

Chapter 25 Outline

Managed housing
Classification of member obligations
Assessments generate revenue
The buyer's expectations about assessments
Order in the financial house
HOA assessment enforcement policy
HOA documentation
Seller's agent's role

Chapter 25 Terms

Annual operating costs	*Pro forma operating budget*
Common interest development	*Regular assessment*
Covenants, Conditions & Restrictions	*Special assessment*
Extraordinary expenses	*Statement of conditions of assessments*
Homeowners' association	*Transparency*

Managed housing

A buyer seeking to acquire a unit in a condominium project, or in any other residential *common interest development* (CID), is **bargaining for** living restrictions and ownership operating costs unlike those experienced in the ownership of a self-managed, single-family residence (SFR).

Ownership of a unit in a condominium project includes compulsory membership in the *homeowners' association* (HOA). The HOA is charged with **managing and operating** the entire project.

As a common owner of the project and a HOA member, **use and operating restrictions** are placed on most types of conduct, including:

- parking;
- pets;
- guests;

- signs;
- use of the pool, recreational and other like-type common facilities;
- patio balconies;
- care and maintenance of the unit;
- structural alterations; and
- the leasing of the premises.

The implicit bargain in becoming an owner-member is consenting to conform his conduct to meet extensive **use restrictions** in exchange for every other owner-member doing the same. The standards for the conduct consented to are found in the use restriction documents created for the project, such as association bylaws, *Covenants, Conditions and Restrictions* (CC&Rs) and operating rules.

The HOA has committees and a board of directors, both consisting of owner-members who are appointed to oversee the conduct of all the owner-members and their guests. On a committee's recommendation concerning a member's violation of a restriction, rule or policy of the HOA, the HOA takes steps to enforce compliance, usually by a notice of violation to the offending owner-member.

A fair comparison to the member's occupancy in a **multiple-unit housing project**, such as a condominium development, is a tenant's occupancy in an apartment complex of equal quality in construction, appearance and location. The behavior of a tenant in an apartment is also controlled by use restrictions, operating rules and policies established by a landlord.

However, a landlord is subject to market conditions when establishing guidelines for tenant conduct. Unlike a HOA, a landlord dues not rule by majority vote, committees and directors.

Yet the conduct of tenants is regulated and policed in very much the same way as the conduct of a member of a condo project is policed. In law, **security arrangements** required to be implemented and maintained for condo projects and apartment complexes are the same, i.e., the property is to be maintained so its use is safe and secure from dangerous defects and preventable criminal activity. Both the landlord and the board of directors of a HOA are responsible for the safety of the users of their respective multiple-housing projects. Both are managed housing.

Classification of member obligations

The bargain entered into on acquiring a unit in a CID must be understood by the prospective buyer to include a highly involved **socio-economic relationship** with all other members of the project's HOA. A commonality of interest arising out of CID ownership creates a relationship amongst the members built not only on **use restrictions** and operating rules, but also on **financial commitments** to one another.

Financially, all members collectively provide all the revenue the HOA needs to pay the expenses of present and future repairs, restorations, replacements and maintenance of all components of the structures they own in common or through the HOA.

Thus, the obligations undertaken by a prospective buyer who acquires a unit in a CID, and the HOA's documentation of those obligations, fall into two classifications:

- **use restrictions** contained in the association's articles of incorporation, by-laws, recorded CC&Rs, age restriction statements and operating rules; and
- **financial obligations** to pay assessments as documented in annual reports entitled pro forma operating budgets, a Certified Public Accountant's (CPA's) financial review, an assessment of collections and enforcement policy, an insurance policy summary, a list of construction defects, and any notice of changes made in assessments not yet due and payable.

Assessments generate revenue

Two types of assessment charges exist to fund the expenditures of HOAs:

- *regular assessments*, which fund the operating budget to pay for the cost of maintaining the common areas; and
- *special assessments*, which are levied to pay for the cost of repairs and replacements that exceed the amount anticipated and funded by the regular assessments.

Annual increases in the dollar amount levied as **regular assessments** are limited to a 20% increase in the regular assessment over the prior year. An increase in **special assessments** is limited to 5% of the prior year's budgeted expenses. [Calif. Civil Code §1366(b)]

An *extraordinary expense* brought about by an emergency situation lifts the limits placed on the amount of an increase in regular and special assessments. **Extraordinary expenses** include amounts necessitated:

- by a court order;
- to repair life-threatening conditions; and
- to make unforeseen repairs. [CC §1366(b)]

The schedule for payment of assessments by a member varies depending on the type of assessment. **Regular assessments** are set annually and are due and payable in monthly installments. **Special assessments** are generally due and payable in a lump sum on a date set by the HOA when making the assessment.

The buyer's expectations about assessments

To better understand the impact of assessment obligations, a prospective buyer of a unit needs to analyze the assessments based on:

- the present and future *annual operating costs* the HOA will incur; and
- the amounts which must be set aside annually as **reserves** for future restoration or replacement of major components of the improvements.

Should the association's reserves be insufficient to pay for major repairs to components of the structure which were foreseeable, a **special assessment** is used by the association to immediately call for additional funds from members to provide revenues to cover these extraordinary or inadequately reserved expenditures.

Arguably, repairs and replacements for which assessment revenues are needed to cover HOA costs are expenses any owner of a SFR would also incur. However, the difference in a CID is the individual member cannot substitute his time, effort and personal judgment for how much will be paid, when the repairs will take place, how repairs might be financed or exactly what repairs or quality of repairs are appropriate. These decisions are left to HOA committees who hopefully vote based on the same concerns and ability to pay as would the prospective buyer of a unit.

Order in the financial house

To determine if a HOA has its finances in order, a prospective buyer should look to the financial reports held by the seller or readily available from the HOA on the seller's request.

The HOA's current *pro forma operating budget* is the starting point for the prospective buyer's analysis of the financial impact the purchase of a unit in the CID will have on his income. Remember, it is the **regular assessments** which will be increased if reserves are inadequate and a **special assessment** which is levied to cover an immediate expenditure for which insufficient cash reserves exist.

The **pro forma operating budget** makes several mandatory disclosures about the state of the HOA's finances, including, but not limited to:

1. An estimate of the revenues from assessments, paid or delinquent, and the **expenses** the HOA anticipates incurring during the fiscal year covered by the budget. The revenues must exceed expenses since the HOA must set aside cash reserves for the future replacement of major components of the structure.
2. A summary of the HOA's **cash reserves** itemizing:

- the estimated repair or replacement cost of each major component of the structure owned by the HOA;

- the amount of cash reserves needed to pay for the repairs or replacements of these major components; and

- the cash reserves actually on hand and available to pay for these repairs or replacements.

3. Any determination or anticipation of the HOA's board of directors as to whether **special assessments** will be required in the future for reserves, repairs, replacements or maintenance. [CC §1365(a)]

On review of the HOA's pro forma operating budget, the prospective buyer can quickly determine whether cash reserve shortages exist. If they do exist, the only way for the HOA to get the funds into reserves or immediately pay for the repairs or replacements is to increase the regular assessments (which are paid monthly) or call for a special assessment (which will be a lump sum amount due and payable when set).

Thus, when setting the purchase price of a unit, the buyer must consider (the present value of) the amount of **deferred assessments** he will have to pay in the future, assessments which should have been levied and paid by the seller.

Some HOAs initially supply only a **summary** of the pro forma operating budget. In this case, the full budget can be requested and will be delivered without further charge.

Further, the prospective buyer needs to review additional HOA documents to fully **determine the value** (price) of the unit he is interested in purchasing and the **financial impact** assessments will have on the buyer's disposable income.

HOA assessment enforcement policy

Also available from the HOA is a statement on the HOA's policies for enforcing collection of delinquent payments of assessments. [CC §1365(e)]

At issue for a prospective buyer of a unit is the method used by the HOA to **enforce collection** of assessments, e.g.,:

- does the HOA **record a Notice of Default** and proceed with a trustee's foreclosure on the owner's unit, a default which can be cured by the payment of delinquencies and statutorily limited foreclosure costs; or

- does the HOA **hire an attorney and file a lawsuit** requiring a response, a trial and results in a personal money judgment against the owner, all of which has no limit on the dollar amount of costs and attorney fees to defend or prosecute and, if not paid, becomes an abstract of judgment which is a foreclosable lien on all property owned by the owner and collectible by attaching the owner's wages or salary. [CC §§1367, 1367.1]

The prospective buyer of a unit in a CID needs to review all readily available HOA information with the buyer's agent **before making an offer**. With this information, the property's fundamentals

become more **transparent**, allowing the buyer and his agent to better determine the price the buyer should pay for the unit and whether or not he has the ability (and desire) to carry the cost of ownership after acquisition.

HOA documentation

An **association's participation** in a seller's agent's efforts to induce a prospective buyer to enter into a purchase agreement and close escrow on the sale of a unit located within the project is limited to:

- **providing the seller's agent**, on written request from the owner of the listed unit, with documents which include items, statements and reviews regarding the permissible use of the unit and the financial condition of the HOA [CC §1368(b); see **first tuesday** Form 135];

- **providing escrow**, on written request from the owner of the listed unit, with documents which include notices, statements, lists and disclosures regarding the status of the owner's membership in the HOA; and

- **changing HOA administrative records** to reflect the identification of the new owner should the prospective buyer purchase the unit.

The association documents regarding use restrictions and financial data should be delivered by the seller's agent, also referred to as a *listing agent*, to a prospective buyer prior to entering into a purchase agreement. When disclosures are received before agreeing to buy, the buyer does not have a valid reason to later use this information to terminate the purchase agreement.

Status documents are also available from the HOA on request (usually by escrow) prior to closing. Using these documents, the buyer confirms the owner's representations in the purchase agreement about the status of his occupancy and the assessments imposed on the unit he is selling.

Escrow's only concern with HOA documents is the receipt of information for the purpose of prorations made necessary by prepaid or delinquent assessments.

The closing documents needed by escrow and the buyer regarding the owner's status with the HOA include:

- the CID's *statement of condition of assessments* in order for escrow to calculate **prorates and adjustments** on closing; and

- any HOA notices to the owner of CC&R violations, a list of construction defects and any assessment charges not yet due and payable in order for the buyer to **confirm the representations** made by the owner in the purchase agreement.

Seller's agent's role

Unless a seller's agent is remiss, or simply ignorant of his duties owed to prospective buyers, he knows exactly what CID information and documents he needs to gather to properly **market and disclose** to prospective buyers the material facts about a condominium unit he has listed for sale, called *transparency*.

Accordingly, it is at the listing stage that the agent should prepare the **owner's request** to the HOA to deliver up the CID documents concerning use restrictions and HOA finances. The documents are immediately available from the association and will be delivered within 10 days of the posted or hand delivered request. [CC §§1368(a), 1368(b); see **first tuesday** Form 135]

The owner is obligated by statute to ensure the disclosures are handed to prospective buyers as soon as practicable (ASAP). It is quite easy for the owner to request and quickly receive the documents from the association. Thus, the ready availability of the documents confirms the disclosures can, as a practical matter, be made available to a prospective buyer before the owner accepts an offer. [CC §1368(a)]

However, once the owner lists the property, it becomes the **seller's agent's obligation**, acting on behalf of the owner, to diligently fulfill the owner's obligation to make the association documents available for delivery to prospective buyers, ASAP.

Chapter 26 — Conflict of interest

This chapter demonstrates a broker's use of a Conflict of Interest Disclosure to avoid breaching the fiduciary duty he owes to his client when he has a bias relating to the opposing party in a transaction, or another, whose interests are in conflict with his client's.

For a further discussion of this topic, see Chapter 6 of Real Estate Practice.

Chapter 26 Outline

Professional relationships compromised
Situations involving a conflict
Relative's participation in a transaction
A relative owns the property sold
Taking a fee when acting as a principal
The licensee acts solely as a principal
Conflicts in real estate syndication
Compensation and earnings received by the broker

Chapter 26 Terms

Agency dilemma	*Element of deceit*
Compromise	*Inherent bias*
Conflict of interest	*Ownership interest*
Dual agency situation	*Special pre-existing relationship*

Professional relationships compromised

A conflict of interest arises when a broker or his agent, acting on behalf of a client, has a competing professional or personal bias which hinders his ability to unreservedly fulfill the fiduciary duties he has undertaken to advise and act on behalf of the client.

In a professional relationship, a broker's financial objective of **compensation for services** rendered by the broker is not a conflict of interest. However, fees and benefits derived from professional courtesies, familial favors, and preferential treatment by others toward the broker or his agents as compensation which must be **disclosed** to the client. [See **first tuesday** Form 119]

Further, the referral of a client to a financially controlled business, owned or co-owned by the broker, must be disclosed by use of an affiliated business arrangement (ABA) form, and is also not a conflict of interest. [See **first tuesday** Form 519]

A **conflict of interest** addresses the broker's personal relationships potentially at odds with the agency duty of care and protection owed the client.

Thus, a conflict of interest creates a fundamental *agency dilemma* for brokers, not a compensation or business referral issue.

A **conflict of interest** exists when:

- a broker has a positive or negative bias toward the opposing party in a transaction or a person indirectly involved in the client's transaction; and

- that bias in favor of or against the other person might compromise the broker's ability to freely recommend action or provide guidance to the buyer or seller, landlord or tenant, or lender or broker he agreed to represent.

This bias regarding an opposing person or a party not directly involved, to whom the broker may or may not also owe an agency duty, must be disclosed if the bias might disrupt the broker's ability to make impartial decisions about the care and protection he owes his client. Unless disclosed and the client consents, the conflict is a breach of the broker's fiduciary duty of good faith, fair dealing, and trust owed to his client should the broker continue to act on the client's behalf. [See Figure 1, **first tuesday** Form 527]

Situations involving a conflict

A conflict of interest, whether patent or potential, is disclosed by the broker at the time or as soon as possible after the conflict arises. Typically, the conflict arises prior to providing a buyer with property information or taking a listing from a seller.

The disclosure creates transparency in the transaction, revealing to the client the bias held by the broker which, when disclosed, allows the client to take the bias into consideration in negotiations. Though the disclosure and consent does not neutralize the *inherent bias* itself, it does neutralize the *element of deceit* which would breach the broker's fiduciary duty if left undisclosed.

Potential overlaps of allegiance or prejudice which cause a **conflict** that a broker or his agent must disclose include:

- the broker or his agent holds a direct or indirect ownership interest in the real estate, or are directly or indirectly a buyer of the property in the transaction, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing, or lending on the property;

- an individual related to the broker or one of his agents by blood or marriage holds a direct or indirect ownership interest in the property or is the buyer;

- an individual with whom the broker or a family member has a special pre-existing relationship, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold, or security interest in the property or is the buyer;

- the broker's or his agent's concurrent representation of the opposing party, a dual agency situation; or
- an unwillingness of the broker or his agent to work with the opposing party, or others, or their brokers or agents in a transaction.

Simply, a **conflict of interest** arises and is disclosed to the client when the broker:

- has a pre-existing relationship with another person due to kinship, employment, partnership, common membership, religious affiliation, civic ties, or any other socio-economic context; and
- that relationship might hinder his ability to fully represent the needs of his client.

Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed. Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third parties arise. In practice, brokers, and especially agents, all too often err on the side of nondisclosure, putting their brokerage fee, if not their license itself, at risk.

Generally, if a broker even questions whether it is appropriate to disclose a potential conflict of interest to a client, he should disclose it. The existence of any concern is reason enough for a prudent broker to be prompt in seeking his client's consent to the potential conflict. By timely disclosing a conflict of interest and obtaining consent, the broker immediately creates an honest working relationship with his client.

The client's tardy discovery of the conflict and their complaint to the Department of Real Estate (DRE) for failure to make the disclosure and obtain consent before continuing to advise or act on behalf of the client can result in the suspension or revocation of the broker's license by the DRE. [Calif. Business and Professions Code §10177(o)]

Fundamentally, a broker who becomes aware he has a conflict of interest but is reluctant to disclose it and seek the client's consent should consider rejecting or terminating the employment with that individual.

Relative's participation in a transaction

A seller's broker must disclose the broker's acquisition of any direct or indirect interest in the seller's property, or whether a family member, a business owned by the broker, or any other person holding a special relationship with the broker (such as his agents) will acquire an interest in the seller's property. [See **first tuesday** Form 527 §3.6]

For example, a broker's brother-in-law makes an offer to buy property the broker has listed. The purchase agreement states the broker is to receive a fee and that he represents the seller exclusively.

The broker does not disclose to the seller that the buyer is his brother-in-law.

Figure 1

first tuesday *Form 527 -*
Conflict of Interest - Kinship, Position or Undue Influence

CONFLICT OF INTEREST
Kinship, Position or Undue Influence

Prepared by: Agent ____________ **Phone** ____________
Broker ____________ **Email** ____________

NOTE: Licensed Brokers and Sales Agents when acting on behalf of a client may not act in a manner which might cause the client to conclude that others, or a position held by the Broker or his Agents, can improperly influence or cause the Broker or his Agents to fail to properly act in their fiduciary capacity as an agent without first disclosing to the client the facts which might otherwise lead to that conclusion and obtaining their consent.

DATE: ____________, 20______, at ____________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:
☐ Listing (Employment) Agreement ☐ Purchase Agreement
☐ Escrow Instructions ☐ ____________

1.1 ☐ of the same date, or dated ____________, 20______, at ____________, California,
1.2 entered into by ____________________, as the ____________, and
1.3 ____________________, as the ____________,
1.4 regarding real estate referred to as ____________________.

2. The client(s) represented by the undersigned Broker with regard to the above referenced agreement is/are identified as the ____________________.

DISCLOSURE OF CONFLICT OF INTEREST:

3. Broker provides the following information as a disclosure to the client of relationships or positions held by Broker or his Agents, and their family members, in investments, business activities or real estate interests which present circumstances that might, if not disclosed, appear to be in conflict with the agency duty owed the client to care for and protect the interests of the client.

Check the following items and enter information on facts which are believed might create a conflict of interest for Broker or his Agents in performing their agency duties on behalf of the client.

3.1 ☐ Real estate
Property type: ____________________
Address: ____________________
Interest held: ____________________
Activity creating conflict: ____________________

3.2 ☐ Government agency
Agency name: ____________________
Position held: ____________________
Activity creating conflict: ____________________

3.3 ☐ Business position
Business name: ____________________
Goods or services provided: ____________________
Position held: ____________________
Activity creating conflict: ____________________

3.4 ☐ Business investment
Company name: ____________________
Type of trade or business: ____________________
Interest held: ____________________
Activity creating conflict: ____________________

— — — — — — PAGE ONE OF TWO — FORM 527 — — — — — —

— — — — — — PAGE TWO OF TWO — FORM 527 — — — — — —

3.5 ☐ Representation of others in transaction
Name of person also owed agency duties: ____________________
Activity creating conflict: ____________________

3.6 ☐ Kinship and employee relationships
Name of individual(s): ____________________
Relationship with Broker or employee: ____________________
Activity creating conflict: ____________________

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for additional compensation and controlled business arrangements. [See **ft** Forms 119 and 519]

BROKER:

5. I certify that the above information is true and correct.

Date: ____________, 20______ Broker's Name : ____________________
By: ____________________
Agent's Name: ____________________

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.

☐ See attached Signature Page Addendum [**ft** Form 251]

Date: ____________, 20______
Name: ____________________ Name: ____________________

Signature: ____________________ Signature: ____________________

FORM 527 03-11

Scan this QR-Code for a PDF of the Form!

The broker opens two escrows to handle the transaction. The first escrow facilitates the sale and transfers the property from the seller to the broker's brother-in-law.

The second escrow is for the sole purpose of transferring title to the property from the brother-in-law to a limited liability company (LLC) in which the broker holds an ownership interest, a syndicated acquisition. Both escrows close and the broker receives his fee.

The seller discovers the buyer to whom he deeded the property was his broker's brother-in-law and that the true buyer was an entity partially owned by the broker. The seller demands a return of the brokerage fee claiming the broker had a conflict of interest which breached the fiduciary duty he owed to the seller since it was not disclosed and the seller did not consent.

Here, the broker is not entitled to retain the brokerage fee he received from the seller. Further, the seller is entitled to recover any property value at the time of the sale in excess of the price he received, or he can set the sale aside, due to the failure of the broker's agency with the seller.

A broker cannot act for more than one party in a transaction, including himself, without disclosing his **dual role** and obtaining the **client's consent** at the time the conflict arises. [Bus & P C §10176(d); see **first tuesday** Form 527]

Also, a seller's broker has an affirmative duty to disclose to the seller his agency or other conflicting relationship he might have with the buyer, even if the seller fails to inquire into whether the broker has a relationship with the buyer.

Further, failure to disclose a broker's personal interest as a buyer in a transaction when he is also *acting as a broker* on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner. [**Whitehead** v. **Gordon** (1970) 2 CA3d 659]

In another example, a seller, acting on a broker's advice as to the estimated value of his real estate, retains the broker to find a buyer for the property. [See **first tuesday** Form 318]

The broker and seller enter into a net listing agreement.

Under the **net listing**, the seller agrees to take a fixed sum of money as the net proceeds for his equity should the property sell. Also, the net listing provides for the broker to receive all further sums paid on the price as his brokerage fee.

The broker arranges a sale of the property to his daughter and son-in-law. The seller is not informed of the broker's relationship with the buyer. On the close of the transaction, the broker receives his fully disclosed brokerage fee as the net proceeds remaining from the sale in excess of the net listing price.

On discovery of the broker's relationship with the buyer, the seller demands a return of the brokerage fee claiming the broker's kinship with the buyer is a conflict of interest which was not disclosed, violating the fiduciary duty he owed to the seller. The broker claims the seller cannot recover the brokerage fee no matter who the buyer was since the seller only bargained to receive a fixed amount on the sale of his property under the net listing agreement.

Here, and whenever a broker is employed under any type of listing, he has an obligation to voluntarily disclose to his seller, and do so at the earliest opportunity, any special relationship he may have with the buyer and obtain the seller's consent before proceeding. The seller, unaware of the family relationship between his broker and the buyer, can recover the brokerage fee he paid to the broker. [**Sierra Pacific Industries** v. **Carter** (1980) 104 CA3d 579]

A relative owns the property sold

A selling broker employed to act on behalf of a buyer will disclose to his buyer the nature and extent of any direct or indirect interest **he or his agents hold** in any property presented to the buyer.

For example, a licensed broker acting as an agent on behalf of a buyer shows the buyer several properties, one of which is owned by the broker and others, vested in the name of an LLC. The broker promptly informs the buyer he has a listing on the property, but does not inform the buyer of his indirect ownership interest in the property.

The buyer later decides to purchase the LLC property. An offer is prepared on a purchase agreement form with an agency confirmation stating the broker is the agent for both the buyer and seller. The offer is submitted to the LLC. [See **first tuesday** Form 159]

The broker, aware the buyer will pay a higher price for the property than the initial price offered by the buyer, presents the buyer with a counteroffer from the LLC at a higher selling price. The buyer accepts the counteroffer.

Here, the broker has a duty to promptly disclose his ownership interest in the property to the buyer the moment the conflict arises – the exposure of the buyer to the property. The conflict of interest in the broker's ownership is a material fact requiring disclosure since the buyer's decisions concerning acquisition of the property might be affected.

As a result of the lack of disclosure of the conflicting position of the buyer's broker, the buyer can recover the fee received by the broker and the increase in price under the counteroffer.

Had the buyer known the broker held an ownership interest in the property when it was first presented, he might have negotiated differently when setting the price and terms for payment, or retained a different broker to represent his interests who was not compromised by a conflict of interest.

However, a broker acting solely **as a principal** in the sale of his own property is not restricted in his conduct by compliance with agency obligations. The broker selling or buying property for his own account should act solely as the seller or buyer, rather than pay himself a taxable fee for **also acting as a broker** in the transaction which then exposes him to claims of agency violations. [**Robinson** v. **Murphy** (1979) 96 CA3d 763]

Taking a fee when acting as a principal

When a **broker-seller** receives a brokerage fee on the sale of his own property or on the purchase of property for his own account, he subjects himself to real estate agency requirements.

For example, a broker sells a residence he owns which exists in violation of safety requirements for occupancy due to defects in the foundation known to the broker. The broker does not tell the buyer about the foundation defects.

Out of the proceeds the broker receives on closing the sale of his property, the broker-seller pays himself a brokerage fee, claiming to *exclusively represent himself* (which is not an agency and does not require a license).

The buyer later discovers he must demolish the residence and rebuild it with an adequate foundation. The buyer obtains a money judgment against the broker for breach of his general agency duty owed to all parties in a real estate transaction to disclose known property defects that cause the buyer to take a loss.

The broker is unable to pay the money judgment. The buyer seeks payment from the DRE Recovery Fund.

Recovery is received from the DRE Recovery Fund since the broker held himself out as a**cting as a real estate** broker in the transaction – he received a fee. The broker's license is then suspended. Before the broker can reactivate his license, he must reimburse the DRE Recovery Fund. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

The licensee acts solely as a principal

A DRE licensee acting solely as a principal on his own behalf when buying (or selling) property need not disclose the existence of his real estate license. The licensee has no conflict due to the **existence of his license** since he is not holding himself out as a broker or agent acting on behalf of another person in the transaction.

Consider a broker who is employed by an owner to arrange a real estate loan. The lender making the loan is the broker's sister.

The broker, however, funds the loan himself by depositing his personal funds into his sister's account. In essence, the broker is the lender.

The owner is not advised of the kinship between the broker and the lender, or of the true source of the loan funds. [See **first tuesday** Forms 205-1 and 205-2]

Here, the broker has a duty owed to the buyer to disclose his **dual capacity** in the loan transaction. He was acting both as a broker arranging the loan on behalf of the owner and as the lender making the loan, a conflict of interest. The broker's actions constitute grounds for discipline by the Real Estate Commissioner. [**Tushner** v. **Savage** (1963) 219 CA2d 71]

Conflicts in real estate syndication

A potential conflict of interest also exists when a broker **manages multiple LLCs** which own like-type properties in the same market area, the result of his syndicating the acquisition of several properties.

For example, consider a broker entrusted with managing two investment groups which own similar apartment projects located within the same market and compete for the same prospective tenants. The broker is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the broker is initially faced with the dilemma of which apartment building to refer the tenant to and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions in which multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

A conflict of interest of this nature must be disclosed to the investors before they agree to participate as members in an LLC the broker manages. This disclosure is contained in first tuesday Form 371, Investment Circular provision 6d, which states:

- The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property. [See **first tuesday** Form 371]

With this disclosure, the **broker's allegiance** to multiple projects and investment groups is transparent and can be taken into consideration by all investors at the time they receive the Investment Circular from the Broker – before investing and consenting to the risk.

Compensation and earnings received by the broker

Direct or indirect compensation received by a broker must be disclosed to his client but not as a conflict of interest. A Compensation Disclosure form is prepared, setting forth the amount of compensation, its form and source as additional benefits the broker and his agents anticipate receiving for any other service they provide as a result of the client's entry into a real estate transaction in which the broker is acting as a licensee. [Bus & P C §10176(g); see **first tuesday** Form 119]

Additionally, a broker listing a property or representing a buyer who refers the owner or buyer to a business or service **provider he owns** or co-owns uses an Affiliated Business Arrangement

Disclosure Statement to inform the party of his ownership interest in that company. The disclosure enables the broker to indirectly benefit from the referral and properly share in any profits from the referrals he makes to businesses he controls. [See **first tuesday** Form 519]

Similarly, the Affiliated Business Arrangement Disclosure Statement – Loan Broker form is used by a mortgage loan broker arranging financing when referring a borrower to providers of settlement services whose earnings are shared by the loan broker as a co-owner of the provider. [See **first tuesday** Form 205]

Real estate ownership concepts

Chapter 27 California real estate law

This chapter reviews the two primary historical sources of California real estate interests and conveyances.

For a further discussion of this topic, see Chapter 1 of Real Estate Legal Aspects.

Chapter 27 Outline

The English and Spanish influence
American rule
Authority to legislate
Eminent domain
The power to tax
Federal and state law conflicts
Administrative agencies

Chapter 27 Terms

Administrative agency	*Police power*
Eminent domain	*Rent control ordinance*
English common law	*Spanish civil law*
Condemnation	*Tax*
Land commission	*Treaty of Guadalupe Hidalgo*

The English and Spanish influence

Historically, California real estate law has been influenced by two key sources of human conduct:

- the English legal system, or common law; and
- the Spanish legal system, or civil law.

The **common law** of England has been the predominate influence and was officially adopted by California soon after obtaining statehood in 1850. [Calif. Civil Code §22.2]

The **civil law** of Spain, while less influential, has nevertheless had a significant impact on California real estate law.

Also, many land titles in California are based on Spanish and Mexican land grants, as are water rights.

American rule

The Mexican-American War ended with the signing of the Treaty of Guadalupe Hidalgo.

Under the treaty, the United States agreed to acknowledge the existing land grants conveyed by the Spanish and Mexican governments.

The United States set up a *land commission* to document the validity of the land grants. The land commission established land titles and created the chain of title still used for all California real estate today.

After confirmation of a valid land grant, the land was surveyed by the federal government and conveyed to the rightful owner by a United States *patent deed*.

All land not under a valid claim became part of the public domain of the United States.

In 1850, the United States granted part of the unclaimed real estate to the State of California. The balance was retained by the federal government.

While the **land commission** worked in a proficient and fair manner, the United States government was slow to approving many claims. Many rancheros had to wait years, even decades, before receiving a **patent deed** from the United States government.

Survey delays and protracted litigation were the prime culprits for the demise of the last ranchos. Additionally, Spain and Mexico had no recording or land indexing system to perfect and identify title to real estate.

During the appeal time, the real estate was unmarketable since most buyers did not want to take the risk of purchasing real estate with unprotected title.

Many rancheros, faced with financial ruin, sold off to Yankee speculators.

With Yankee speculators buying, or lending and foreclosing on the lands, the Spanish influence on California real estate law came to an abrupt end.

Authority to legislate

The federal and state legislatures and local governments can only enact laws if they have been given the power to do so by the **United States Constitution** or the **California Constitution**. [U.S. Const., Art. I]

The authority of the California legislature to enact laws regulating real estate activities comes from three main constitutional powers:

- the police power;
- the power of eminent domain; and
- the power to tax.

The United States Constitution confers on California the right to enact laws to protect the public health, safety and welfare. [U.S. Const., Amend. X]

The California Constitution confers an equal power to local cities and counties to likewise protect the public good. [California Constitution, Article XI §7]

This power to protect the public well-being is called *police power*. **Police power** is the source of the state or local government's authority to act.

Police power is the basis for laws governing such things as highway construction and maintenance, rent control, zoning and traffic. [**Village of Euclid, Ohio** v. **Ambler Realty Co.** (1926) 272 US 365]

A statute or ordinance passed under the government's constitutional police power and affecting real estate related activity will be valid as long as the law:

- is fair and reasonable;
- addresses a legitimate state interest;
- does not unreasonably burden the flow of interstate commerce; and
- does not conflict with related federal law.

Eminent domain

The second key power of the state to regulate real estate is the power of *eminent domain*. [Calif. Const., Art. 1 §19]

Eminent domain is the right of the government to *take* private property for public use.

However, the government must pay the owner the fair market value of the property taken. [**Loretto** v. **Teleprompter Manhattan CATV Corp.** (1982) 458 US 419]

The process of using the power of eminent domain is called *condemnation*.

Examples of eminent domain include condemning property to provide highways and roads, establish parks, construct flood control levees and provide land for redevelopment.

The power to tax

State and local governments also regulate the crucial **power to tax** real estate activities to generate revenue and fund state and local governmental functions under their police power. [Calif. Const., Art. XIII D §6]

For example, a city passes an ordinance which imposes an **inspection fee** on all landlords renting residential properties. The fee charged is based on a flat rate per unit, not on current property values.

A landlord subject to the ordinance claims the ordinance is unenforceable since the city must have voter approval before adopting an ordinance which would impose a regulatory fee on property.

The city claims the ordinance is enforceable without voter approval since the fee is imposed on a **use** of the property — renting — not on the mere ownership of the property, which would require voter approval.

Here, the ordinance imposing the inspection fee on landlords based on a flat rate is enforceable. Voter approval is only required when fees and taxes are imposed on owners simply because they own real estate. Fees and taxes imposed on the owner's exercise of his uses and rights which come with owning the property do not require voter approval. [**Apartment Association of Los Angeles** v. **City of Los Angeles** (2001) 24 C4th 830]

Federal and state law conflicts

The states have the sovereignty to regulate within their own borders. At the same time, the federal government has the right to regulate local activities affecting commerce.

What happens when federal and state law conflict? Consider the following example.

An airport is established under the Federal Aviation Act of 1953. The airport expands its number of late night and early morning flights. The residents around the airport complain of the noise during late and early hours.

The city where the airport is located passes an ordinance restricting the number of flights between 11 p.m. and 7 a.m.

The airport objects, claiming it was established under the sole jurisdiction of federal law and the Federal Aviation Act of 1953 set forth by the Federal Aviation Administration (FAA) which has no restriction on flights between 11 p.m. and 7 a.m.

Does the federal law *preempt* (supersede) state law?

Yes! The goals of national flight service and the role of the FAA outweigh local laws inhibiting flight times. [**City of Burbank** v. **Lockheed Air Terminal, Inc.** (1973) 411 US 624]

A federal law will **preempt** state and local statutes and ordinances when:

- the federal interests outweigh local interests;
- the federal law is so pervasive as to exclude inconsistent state law; and
- inconsistent treatment nationwide would result if state law controls.

Thus, it is possible for federal and state law to regulate the same real estate activity.

For example, there are federal and state fair housing laws prohibiting discrimination. Both the state and federal governments can regulate **fair housing**. The state may provide more but cannot afford less protection than the federal law. [CC §51]

Administrative agencies

As general real estate law becomes more specialized, the role of administrative agencies become increasingly important.

Many **administrative agencies** are given the powers of all three branches of the government: legislative, executive and judicial.

For example, consider a rent control board established by a local city council under *rent control ordinances*.

The board is given authority to enact regulations to implement the **rent control ordinance**. This enactment of regulations is a legislative activity.

The board is also given the power to hear disputes between tenants and landlords, and dispense penalties for a landlord's failure to comply with the law. This is a judicial activity.

In this way, the administrative rent control board has the authority to enact regulations (entailing legislative authority) and hear disputes and administer penalties for noncompliance (entailing judicial authority).

A landlord can always challenge the board in court to determine whether the board has overstepped its power.

The trend with the courts is to continue to give administrative agencies the necessary powers to judge cases involving their own regulations. Thus, the courts themselves are relieved of processing and resolving these disputes.

Chapter 28 The real estate exists

This chapter discusses the physical aspects of real estate, the many legal interests which can be held in real estate and the use of real estate interests.

For a further discussion of this topic, see Chapter 6 of Legal Aspects of Real Estate.

Chapter 28 Outline

Chapter 28 Terms

Appurtenances	*Legal description*
Appropriation	*Lien*
Common interest development (CID)	*Possession*
Corporeal hereditament.	*Profit a prendre*
Divided interests	*Property*
Fixture	*Realty*
Fugacious matter	*Riparian right*
Inverse pyramid	*Severance*
Lease	*Title*
Leasehold estate	

Physical and legal aspects

For a majority of people, the term *property* means a physical or tangible **thing**; something which is owned, such as land, a car or a share certificate. However, **property** is more broadly defined, focusing on the *rights* which arise out of the object. Thus, property is sometimes referred to as a **bundle of rights** in a thing, which for the purposes of this material is specifically real estate.

Additionally, **property** is anything which can be owned. In turn, *ownership* is the **right to possess** the property owned and use it to exclude others from entry. [Calif. Civil Code §654]

The **right to possess** and use property includes the right to:

- occupy;
- sell or dispose;
- encumber; or
- lease the property.

Next, the **types of property** are divided into two primary categories:

- real estate, sometimes called *real property* or *realty*; and
- personal property, sometimes called *personalty*. [CC §657]

Real estate, or real property, is characterized as **immovable**, whereas personal property is **movable**. [CC §§659, 655]

Personal property is defined, by way of exclusion, as all property which is not classified as real estate. [CC §§658, 663]

In fact, personal property was once called *chattel*, a word derived from the word "cattle", cattle being a movable thing.

While the distinction between real estate and personal property seems apparent at first glance, the difference is not always so clear.

Cutting up the real estate

Real estate can be physically cut up by *severance* of a part of the earth (i.e., removal of minerals). *Title* to real estate can also be cut up in terms of time, providing *sequential ownership*.

For example, fee ownership can be conveyed to one person for life, and on their death, transferred by the fee owner to another. Time sharing is another example of the allocation of ownership by time, such as the exclusive right to occupy a space for three weeks during the year.

Title to real estate can also be *fractionalized* by concurrently vesting title in the name of co-owners, such as tenants in common who each hold an undivided (fractional) ownership interest in the real estate.

Possession to real estate can be cut out of the fee ownership for a period of time. For instance, the fee owner of real estate acting as a landlord conveys possession of the property to a tenant under a lease agreement for the term of the lease, called a *leasehold estate* or, simply, a *lease*. When the tenancy expires or is terminated, possession of the property will *revert* to the landlord. The landlord retains fee title to the real estate at all times.

Possession can also be cut up by creating *divided interests* in a property, as opposed to undivided interests. For example, an owner can lease a portion of his property to a tenant. The tenant, in turn, can sublease a portion of his space to yet another person. Another example of *divided interests* is the co-ownership of a property which gives each co-owner the exclusive use of a specific portion of the real estate they jointly own.

Other interests in real estate can be created, such as *liens*. **Liens** are interests in real estate which secure payment or performance of a debt or other monetary obligation. A trust deed loan or a local property tax are examples of liens. On nonpayment of a lien amount, the lienholder can force the sale of the real estate to pay off and satisfy the lien.

Thus, an owner's rights in a parcel of real estate extend beyond the mere physical aspects of the land, airspace and improvements located within the legally described boundaries of the property.

Real estate components

Consider a real estate lender who is concerned about the interest he will hold in a parcel of real estate as security for his loan, such as is provided by a trust deed lien on the entire fee, the fee subject to outstanding leaseholds, or a lien on only the tenant's leasehold interest.

Also, consider a tenant who makes improvements or adds fixtures to his leased premises who is concerned about whether he may or must remove the additions on termination of his tenancy, or whether they must remain as part of the real estate.

The **physical components** of real estate include:

- the land;
- anything affixed to the land;
- anything appurtenant (incidental rights in adjoining property) to the land; and
- anything which cannot be removed from the land by law. [CC §658]

Real estate includes buildings, fences, trees, watercourses and easements within a parcel's horizontal and vertical boundaries. Anything below the surface, such as water and minerals, or above the surface in the air space, such as crops and timber, is part of the real estate.

For example, the rental of a boat slip includes the water and the land below it, both of which comprise the total of the rented real estate. Thus, landlord/tenant law controls the rental of the slip. [**Smith** v. **Municipal Court** (1988) 202 CA3d 685]

In the case of a condominium unit, the air space enclosed within the walls is the real estate. The structure itself, land and air space outside the unit are the property of the association or all the owners of the separate parcels of air space within the condominium project, creating what is called a *common interest development (CID)*. [CC §1351(f)]

A parcel of real estate is located by circumscribing its *legal description* on the face of the earth. Using the property's legal description, a surveyor locates and sets the corners and *horizontal boundaries* of the parcel.

The **legal** and **horizontal boundary** description of the real estate is contained in deeds, the public records of the county in which the parcel is located, subdivision maps or government surveys relating to the property.

However, real estate is three dimensional and reaches perpendicular to the horizontal boundary. In addition to the surface area between boundaries, the classic definition of real estate consists of the soil below to the core of the earth as well as the air space above to infinity. All permanent structures, crops and timber within this *inverse pyramid* are also a part of the parcel of real estate. The three dimensional aspect of real estate has its source in the English common law. [CC §659]

However, in the modern world, the common law definition of real estate has been radically altered to conform to the changing demands of society.

Land

The first component of real estate is *land*. **Land** includes:

- soil;
- rocks;
- other materials of the earth; and
- the reasonable airspace above the earth. [CC §659]

The soil and solid materials, such as ores and minerals, are considered land while they remain undisturbed as a part of the earth.

For example, unmined gold dormant in the earth is real estate.

However, when the gold is mined and removed from its surrounding rock, it becomes personal property since it is no longer embedded in the earth. The gold has been converted from something relatively immovable — part of the rock below the soil — to something movable.

Minerals in the soil are *severable* from the earth. Also, fee ownership to the soil and minerals can be conveyed away from the ownership of the remainder of the land.

When ownership to minerals in a parcel of land is transferred, the transfer establishes two fee owners of the real estate located within the legal description — an owner of the surface rights and an owner of the mineral rights beneath the surface. They are not co-owners of the real estate, but are owners of separate vertically located portions of the same real estate.

Both fee owners are entitled to reasonable use and access to their ownership interest in the real estate.

For example, an owner sells and conveys the ownership right to extract minerals to a buyer. On conveyance, there now exists a surface owner and a mineral rights owner.

Later, the surface owner conveys the real estate to a developer. The developer subdivides the parcel of real estate and plans to construct homes on the lots.

The mineral rights owner objects to the construction, claiming the homes, if built, would completely interfere with his right to enter the property and remove his minerals.

Is the mineral rights owner entitled to enter the property to remove the minerals?

Yes! But only as is reasonably necessary to use his mineral rights. The rights of the surface owner and the mineral rights owner are balanced to determine the precise surface location to be used to extract the minerals. [**Callahan** v. **Martin** (1935) 3 C2d 110]

The right to enter the property to remove minerals exists even if the documents conveying the mineral rights fail to provide for the right of entry. [**Wall** v. **Shell Oil Company** (1962) 209 CA2d 504]

The right to remove minerals from another's real estate is called a *profit a prendre.*

Oil and gas

Unlike solid minerals which are stationary, oil and gas are mobile. Legally, oil and gas are referred to as being *fugacious matter*, since they are transitory.

Oil and gas are perpetually escaping and percolating under the earth's surface. Due to their fleeting nature, a real estate owner does not hold title to the physical oil and gas situated under the surface of his real estate.

At any given time, a real estate owner will have more or less oil or gas depending on gravity and the earth's movements. The ownership interest in the oil and gas unremoved is legally referred to as a *corporeal hereditament*.

In California, oil and gas are incapable of being owned until they are actually possessed — that is, when they have been removed, thus becoming personal property. [Callahan, *supra*]

A fee owner has the exclusive **right to drill** for oil and gas on his premises, unless that right has been conveyed away to others.

Rather than owning the physical oil and gas, the fee owner has a right, called an *incorporeal hereditament*, to remove the oil or gas for his own purposes. [**Gerhard** v. **Stephens** (1968) 68 C2d 864]

Frequently, the right to remove minerals, including oil and gas, is conveyed by sale or lease to another in consideration for the payment of royalties on excavation.

Removing oil and gas

An owner of land has the right to extract all the oil and gas brought up from his real estate even if taken from an underground pool which extends into an adjoining owners' real estate. [**Alphonzo E. Bell Corporation** v. **Bell View Oil Syndicate** (1938) 24 CA2d 587]

Oil and gas, being *fugacious*, move in and out of the below surface portion of a parcel of real estate. However, an owner cannot slant drill onto another's property to reclaim the oil or gas that has flowed from his property. [Alphonzo E. Bell Corporation, *supra*]

Airspace

Land also includes the airspace above the surface of a property. Under traditional English common law, the right to airspace continued to infinity. However, modern technological advances have altered the legal view on airspace.

For example, an owner runs a farm near a military airport. Planes frequently fly over the owner's real estate on their ascent from or descent to the airport.

The government decides to expand the military base by extending the runway and using more advanced (and louder) aircraft at the base. The aircraft, on their approach to the airport, now fly directly over the farmer's barn, scaring the animals and causing the farmer financial loss.

The farmer sues the government for trespass on his real estate since the airspace is being occupied by others — the military.

Can the owner keep the aircraft from flying into his real estate?

No! The common law doctrine regarding the ownership of airspace to the edge of the universe is obsolete. The owner only owns the airspace necessary to allow him a reasonable use of his real estate. The farm owner's real estate extends only so far above the surface of the earth as can be reasonably occupied or used in connection with the land. [**United States** v. **Causby** (1946) 328 US 256]

However, when the flight of airborne vehicles intrudes upon an owner's use and enjoyment of his real estate below, the intrusive entry may constitute a *taking* of the real estate. The continued noise and disturbance of low-flying aircraft which impairs the enjoyment or value of land by causing disruption has effectively **taken** something from the owner. Thus, the owner must be compensated for his loss. [Causby, *supra*]

Other blue sky to be sold

The airspace portion of land has also been modernized with the concept of the condominium, a subdividing of the airspace which creates a relationship between the owners of separate adjacent air spaces classified as a corporate security (cooperatives) but now controlled as a *common interest development* (CID) in real estate.

An owner of a condominium unit legally owns the right to occupy the **parcel of airspace** he has acquired which is enclosed between the walls, ceilings and floors of the structure. Included

in these ownership rights are incidental rights of ingress and egress, called *appurtenances*, and exclusive right to use other portions of the real estate for storage and parking, plus an undivided fractional interest in the common areas, directly or through an owner's association. [CC §1351(f)]

Also, the installation of active solar collectors has led to the right of access to sunlight and air which passes through airspace above property owned by others. This right of access to the sun for a solar collector is considered, by statute, an *easement*. [Calif. Public Resources Code §§25980 et seq.; CC §801.5(a)(1)]

Water

Water in its natural state is considered land since it is part of the material of the earth. While water is real estate, the right to use water is an *appurtenant* (incidental) right to the ownership of real estate.

Three key rights in water must be separately understood and appreciated by brokers.

First, the **right to use** water is called a *riparian right*. **Riparian rights** refer to the rights of a real estate owner to take surface water from a running water source contiguous to his land, such as a river or stream. [Calif. Water Code §101]

Second, the **right to take** water can be acquired by *appropriation*. The appropriator of water diverts or **appropriates** water from a river or watercourse to his real estate and puts it to reasonable use. [**In re Water of Hallett Creek Stream System** (1988) 44 C3d 448]

Third, an individual may obtain *prescriptive rights* in water by wrongfully appropriating non-surplus water openly and adversely under a claim of right for an uninterrupted period of at least five years. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

However, all water in the state of California belongs to the people, under state auspices, based on a *public trust doctrine*. Riparian, appropriation, and prescriptive rights are subject to the state's interest in conserving and regulating water use. [Wat C §101]

Affixed to the land

Real estate also includes things which are affixed to the land.

Things may be **affixed to the land** by:

- roots (e.g., shrubs and trees);
- embedment (e.g., walls);
- permanently resting (e.g., structures); or
- physically attached (e.g., by cement or nails). [CC §660]

Things attached to the earth naturally are real estate. Natural fixtures to the land include trees, shrubs, grass, etc. and are called *fructus naturales*.

However, natural items which are planted and cultivated for human consumption and use are fruits of labor, called *fructus industriales*.

Fructus industriales include such things as crops and standing timber. Crops and timber are ordinarily considered real estate. However, industrial crops and standing timber sold under a purchase agreement and scheduled to be removed are considered personal property. [Calif. Commercial Code §9102(a)(44)]

Crops and timber sold separately under a purchase agreement are treated as *constructively severed* even though actual removal has not yet occurred. [**Wilson** v. **White** (1911) 161 C 453]

Fixtures

A fixture is a personal property item which has become permanently attached to real estate so as to become part of the real estate. [CC §660]

When personal property becomes a fixture, it is part of the real estate and is thereafter conveyed with the real estate.

Factors which determine whether an item is a fixture or improvement include:

- relationship of the parties;
- agreement between the parties;
- intention of the parties;
- manner of attachment; and
- adaptability of attachment to the real estate's use. [**San Diego Trust & Savings Bank** v. **San Diego County** (1940) 16 C2d 142]

The most important factor when determining whether an item is a fixture or improvement is the **intent of the parties**.

Intent to make an item a permanent part of the real estate as a fixture is determined by:

- the manner of attachment; and
- the use and purpose of the item in dispute.

When an item is attached to real estate by bolts, screws, cement or the like, the item is a fixture and part of the real estate. However, an item need not be attached to the real estate in this manner to be a fixture. Items of such weight and size that gravity maintains them in place is sufficient to give the item the character of permanence and affixation to be real estate.

Also, the item may be *constructively attached* when the item is a necessary, integral or working part of improvements on the real estate.

Trade fixtures

Fixtures which are used to render services or make products for the trade or business of a tenant are called *trade fixtures*.

Trade fixtures are to be removed by the tenant on termination of the tenancy, unless agreed to the contrary with the landlord. The removal must not unduly damage the real estate. [CC §1019]

Thus, trade fixtures are considered personal property.

The removal of trade fixtures is often negotiated between a landlord and tenant to confirm who has ownership of the fixtures on expiration of the tenancy. [**City of Beverly Hills** v. **Albright** (1960) 184 CA2d 562]

To be considered a trade fixture, a fixture must be an essential part of the tenant's business and its removal must not substantially damage the real estate. An example of trade fixtures would be mirrors, sink bowls, dryers and installed wash stations in a beauty salon. [**Beebe** v. **Richards** (1953) 115 CA2d 589; see Chapter 31]

Appurtenant rights

Real estate also includes any **incidental rights** to the real estate which are not located on the real estate nor reflected on its title, called *appurtenant rights*. **Appurtenant rights** include the right of ingress and egress across adjoining properties. [CC §662]

An *appurtenant easement* is an interest held by an owner of one parcel of real estate to use adjoining real estate.

Under an **appurtenant easement**, an owner's **right to use** adjoining real estate is part of his real estate, although not reflected on the title to his real estate, and is automatically conveyed with the real estate when he sells it.

Appurtenant easements are said to *run with the land*. Thus, these easements are not personal to the owner of the real estate entitled to use them. They cannot be severed or retained by an owner when he sells the real estate since the right of an owner to use an easement is part of the real estate. Appurtenant rights are incidental rights which remain with the real estate they benefit and do not transfer from person to person.

Other appurtenant rights to real estate include the right to the *lateral and subjacent support* provided by the existence of adjoining real estate. For example, the owner of real estate cannot remove soil from his land so as to cause the adjoining real estate to subside or collapse.

Appurtenant rights which benefit an owner cannot be located in the public records by a search of the legal description for the real estate he owns. Appurtenant rights held by an owner of one property are a recorded encumbrance on title to the adjacent property burdened by the appurtenant rights, such as an easement.

Chapter 29 Fee vs. leasehold

This chapter examines the entitlement to possession of real estate held by owners of different interests in a parcel of real estate.

For a further discussion of this topic, see Chapter 7 of Legal Aspects of Real Estate.

Chapter 29 Outline

A matter of possession
Possessory interests in real estate
Fee ownership: unbundling the rights
Life estates and the life tenant
The life estate impairs or improves the fee
Leasehold interests held by tenants
Types of leaseholds
Leaseholds conveying special uses
The rights of others in a property

Chapter 29 Terms

Common interest development	*Leasehold estate*
Controlling life	*Leasehold interest*
Cropping agreement	*Legal description*
Estate	*Life estate*
Estate at will	*Life tenant*
Estate for years	*Master lease*
Farm lease	*Oil, gas, water and mineral lease*
Fee estate	*Periodic tenancy*
Fixed-term tenancy	*Profit a prendre*
Grazing lease	*Real property*
Ground lease	*Royalty*
Holdover tenancy	*Sandwich lease*
Impairment	*Sublease*
Inverse pyramid	*Tenancy-at-sufferance*
Lease	*Tenancy-at-will*

A matter of possession

A parcel of real estate is located by circumscribing its *legal description* on the “face of the earth.” Based on the legal description, a surveyor locates and sets the **corners** and **surface boundaries** of the parcel.

The legal description is contained in deeds, subdivision maps or government surveysregulating to the property.

However, a parcel of real estate is three dimensional, reaching beyond the surface boundaries. In addition to the surface area within the boundaries, real estate consists of the soil below the surface to the core of the earth as well as the air space above it to infinity.

All permanent structures, crops and timber within this *inverse pyramid* are also a part of the parcel of real estate.

A **parcel of real estate** is often mistakenly thought of as a plot of unimproved land. Also mistaken is the notion any improvements can be somehow treated as personal property, unless they are to be removed from the land.

Real estate, sometimes legally called *real property*, consists of:

- the land;
- the improvements and fixtures attached to the land; and
- all rights incidental or belonging to the property. [Calif. Civil Code §658]

Real estate includes buildings, fences, trees, watercourses and easements within the parcel’s boundaries.

Anything below the surface, such as water and minerals, or above the surface in the air space, such as crops and timber, is part of the real estate.

The rental of a boat slip includes the water and the land below it, both of which comprise the real estate. Thus, landlord/tenant law controls the rental of the slip. [**Smith** v. **Municipal Court of San Mateo County** (1988) 202 CA3d 685]

In the case of a condominium unit, the air space enclosed within the walls is the real estate conveyed and held by the owner of the unit. The structure, land and air space outside the unit are the property of the homeowners’ association, creating what is called a *common interest development (CID)*. [CC §1351(f)]

Possessory interests in real estate

The **ownership interests** a person may hold in real estate are called *estates*. Four types of **estates** exist in real estate:

- *fee estates*, also known as inheritance or perpetual estates;

- *life estates*;
- *leasehold estates*, sometimes called *estates for years*; and
- *estates at will*. [CC §761]

In practice, these estates are separated into three categories: fee simple estates, leasehold estates and life estates. Estates at will are part of the leasehold estates controlled by landlord/tenant law.

A **life estate** terminates on the death of the owner of the life estate or the death of another person named in the deed which conveys or reserves the life estate to the owner.

Leasehold interests in the real estate exist for a specific period of time. The interest terminates when the period of time expires.

An **estate at will**, unlike a leasehold, is not conveyed in an exchange for value, called *consideration* or rent. Estates at will terminate at the discretion of the fee owner, subject to proper advance notice. Possession of real estate under leasehold interests and estates at will is controlled primarily by landlord/tenant law.

Fee ownership: unbundling the rights

A fee owner has the right to possess and control his property indefinitely. A fee owner's possession is exclusive and absolute. Thus, the owner has the right to deny others permission to cross his boundaries. No one can be on the owner's property without his consent, otherwise they are trespassing. The owner may recover any money losses caused by the trespass.

A fee owner has the exclusive right to use and enjoy the property. As long as local ordinances such as building codes and zoning regulations are obeyed, a fee owner may do as he pleases with his property. A fee owner may build new buildings, tear down old ones, plant trees and shrubs, grow crops or simply leave the property unattended.

A fee owner may **occupy, sell, lease** or **encumber** his parcel of real estate, give it away or pass it on to his heirs or to anyone he chooses on his death. The fee estate is the interest in real estate transferred in a real estate sales transaction, unless a lesser interest is noted.

A fee owner is entitled to the land's surface and anything permanently located above or below it. [CC §829]

The ownership interests in one parcel may be separated into several fee interests. One person may own the mineral rights beneath the surface, another may own the surface rights, and yet another may own the rights to the air space. Each solely owned interest is held in fee in the same parcel.

Underground oil and gas reserves have a tendency to flow from one place to another. However, the right to extract oil and gas can be separately conveyed by the fee owner of the real estate. The drilling rights separated from the fee ownership are called *profit a prendre*. [**Rousselot** v. **Spanier** (1976) 60 C3d 238]

Profit a prendre is the right to remove profitable materials from property owned and possessed by another, a type of easement if created by a lease agreement. [**Gerhard** v. **Stephens** (1968) 68 C2d 864]

Life estates and the life tenant

A life estate is an interest in a parcel of real estate lasting the lifetime of the *life tenant*. Life estates are granted by a deed entered into by the fee owner, an executor under a will or by a trustee under an inter vivos trust.

Life estates are commonly established by a fee owner who wishes to provide a home or financial security for another person during that person's lifetime, called the *controlling life*.

Life estates terminate on the death of the controlling life. Life estates may also be terminated by agreement or by merger of different ownership interests in the property.

For example, an owner of a vacation home has an elderly aunt who needs a place to live. The owner grants her a life estate in the vacation home for the duration of her lifetime. The aunt may live there for the rest of her life, even if she outlives the fee owner who granted her the life estate.

Although the aunt has the right to exclusive possession of the entire parcel of real estate, the owner retains title to the fee. Thus, the conveyance of a life estate transfers a **right to possession** which has been "carved out" of the fee, comparable to possession under a leasehold interest since it is conveyed out of a fee. Unlike a lease, a life estate does not require rent to be paid.

On the aunt's death, possession of the property *reverts* to the fee owner, his successors or heirs since the right to possession under the life estate is extinguished on the aunt's death.

The holder of a life estate based on his life has the right of possession until death, as though he was the owner in fee. The holder of a life estate is responsible for taxes, maintenance and a reasonable amount of property assessments. [CC §840]

The life estate impairs or improves the fee

However, the holder of a life estate **may not impair** the fee interest. [CC §818]

For instance, the holder of a life estate may not make **alterations** which decrease the property's value, such as removing or failing to care for valuable plants or demolishing portions of the improvements or land.

Conversely, the owner of the life estate has the **right to lease** the property to others and collect and retain all rents produced by the property during the term of the life estate. Profit on the life estate tenant's **sale of the life estate** can be taken in addition to rental income.

In addition, a life tenant is entitled to be reimbursed by the fee owner for the fee owner's share of the costs to improve the property.

Figure 1 *Excerpt from **first tuesday** Form 552 - Nonresidential Lease Agreement*

3. RENT:

3.1 Tenant to pay rent monthly, in advance, on the first day of each month, including rent for any partial month pro rated at 1/30th of the monthly rent per day.

3.2 ☐ Monthly rent for the entire term is fixed at the amount of $_______________.

3.3 ☐ Monthly rent, from year to year, is graduated on each anniversary month as follows:
Initial year's monthly rent to be $_______________, and

a. ______% increase in monthly rent over prior year's monthly rent; or

b. First anniversary monthly rent . . . . $_______________
Second anniversary monthly rent . . . . $_______________
Third anniversary monthly rent . . . . $_______________
Fourth anniversary monthly rent . . . . $_______________

3.4 ☐ Monthly base rent for the initial 12 months of the term is the amount of $_______________, adjusted annually on the first day of each anniversary month by increasing the initial monthly base rent by the percentage increase between the applicable Consumer Price Index for All Urban Consumer (CPI-U) figures published for the third month preceding the month of commencement and the third month preceding the anniversary month.

a. The applicable CPI-U Index (1982-1984 = 100) is:
☐ Los Angeles-Anaheim-Riverside, ☐ San Francisco-Oakland-San Jose,
☐ San Diego, ☐ National, ☐ ____.

b. Rent increases under CPI-U adjustments are limited for any one year to an increase of ______%.

c. On any anniversary adjustment, should the CPI-U have decreased below the CPI-U for the prior twelve-month period, the monthly rent for the ensuing 12 months shall remain the same as the rent during the prior 12 months.

d. If the CPI-U is changed or replaced by the United States Government, the conversion factor published by the Government on the new Index shall be used to compute annual adjustments.

Scan this QR-Code for a PDF of the Form!

Leasehold interests held by tenants

Leasehold interests are the result of rights **conveyed** to a tenant by a fee owner (or by the life estate tenant or master lessee) to possess a parcel of real estate. Leaseholds are created when the landlord and the tenant enter into a lease or a rental agreement that conveys a possessory interest in the real estate to the tenant.

The tenant becomes the owner of a leasehold with the right to possess and use the entire property until the lease expires. The title to the fee interest in the property remains with the landlord (or his successor) throughout the term of the leasehold, subject to the tenant's right to possession, which is carved out of the fee on the fee owner's entry into the lease agreement.

In exchange for the right to occupy and use the property, the landlord is entitled to rental income from the tenant during the period of the tenancy.

Types of leaseholds

Four types of leasehold interests exist and can be held by tenants. The interests are classified by the length of their term:

- a *fixed-term tenancy*, simply known as a *lease* and legally called an *estate for years*;

- a *periodic tenancy*, usually referred to as a *rental*;
- a *tenancy-at-will*; and
- a *tenancy-at-sufferance*, commonly called a *holdover tenancy*.

A **fixed-term tenancy** lasts for a specific length of time agreed to in a lease between a landlord and tenant. [See Figure 1 §3.1; see **first tuesday** Form 552]

On expiration of the lease, the tenant's right to possession automatically terminates unless an agreement, such as an option which is exercised, extends the expiration date or renews or establishes an entirely new tenancy.

Periodic tenancies also last for a specific length of time, such as for a week or a month.

However, in the creation of a periodic tenancy, the landlord and tenant agree to automatic successive rental periods of the same length of time, such as in a month-to-month tenancy.

A **tenant-at-will** has the right to possession of property with the consent of the owner. Tenancies-at-will can be terminated at any time by an advance notice from either party or as set by agreement. Tenancies-at-will do not have a fixed duration, are usually not in writing and a rent obligation generally does not exist.

Leaseholds conveying special uses

In addition to the typical residential and nonresidential leases, there are special purpose leases.

Oil, gas, water and *mineral leases* convey the right to use mineral deposits below the earth's surface.

The purpose of an oil lease is to discover and produce oil or gas. The lease is a tool used by the property owner to develop and realize the wealth of his land. The tenant provides the money and machinery for exploration and development.

The tenant pays the landlord rent, called a *royalty*, and keeps any profits from the sale of oil or minerals he extracts from beneath the surface of the parcel.

A *ground lease* on a parcel of real estate is granted to a tenant in exchange for the payment of rent. Rent is based on the rental value of the portion of the parcel called land, whether the parcel is vacant or improved. The lease is a financing tool for fee owners of vacant, unimproved land to induce others to acquire an interest in the property and develop it.

Ground leases are common in more densely populated areas. Developers often need financial assistance from owners to avoid massive cash outlay to acquire unimproved parcels. Also, owners of developable property often refuse to sell, choosing to become landlords for the long-term rental income they will receive.

An original tenant under a ground lease constructs his own improvements. Typically, the tenant encumbers his ground lease with a trust deed lien to provide security for a construction loan.

Master leases benefit owners who want the financial advantages of renting fully improved property, but do not want the day-to-day obligations and risks of managing the property.

Another type of special-use lease is the *farm lease*, sometimes called *cropping agreements* or *grazing lease*. Here, the tenant operates the farm and pays the landlord either a flat fee for rent or a percentage of the value of the crops or livestock produced on the land.

The rights of others in a property

Easements and *use licenses* are not real estate but they give a holder of the rights a limited and **nonexclusive use** of someone else's property. [See Chapter 43]

An **easement** is a *right to use* another's property for a specific purpose. An easement is an interest in someone else's real estate, as it grants its holder the right to limit the activities of others on the property which is burdened by the easement. [CC §§801 et seq.]

For example, a landowner holds an easement allowing him to construct and have access to a pipeline across his neighbor's property. The neighbor's right to develop his own property is limited since he may do nothing to interfere with the easement owner's access to the pipeline.

A *license* grants its holder a personal privilege to use property, but no right to occupy it to the exclusion of others. Unlike easements, **licenses** are not exclusive rights — an owner may give many licenses to perform the same or different activity in the same area.

Unlike an easement, a license may be revoked at the will of the person who grants it, unless agreed to the contrary or it has become irrevocable.

For example, a landowner wishes to enjoin a neighbor from continuing to use a roadway across the landowner's property that the prior owner of the neighboring property used for ingress and egress to his property. The landowner claims the right to pass is a license, not an easement. The neighbor contends the grant of the right to use the road created an easement.

The landowner claims only a revocable license to use the road was created, as the previous neighbor was only granted a personal *in gross* right to use the road and that right is not assignable to the current neighbor.

Although the previous owner is mentioned, the document creating the right to use a roadway contains the crucial phrase "*his heirs or assigns*" when referring to the prior neighbor's right to use the roadway.

Thus, when the neighbor bought the property he obtained the irrevocable right to use the road as part of his ownership rights. The easement is an *appurtenant right* running with his land since it is physically located on the property of another and is an encumbrance on that property's title.

The roadway document created an easement which entitled the new owner of the neighboring property to cross the adjacent property for ingress and egress to his property from the main road. [**Eastman** v. **Piper** (1924) 68 CA 554]

Covenants, conditions and restrictions (CC&Rs), collectively called *encumbrances*, are recorded against title to a property and limit an owner's right to use his property. By recording restrictions against the title to real estate on a sale, a seller may prohibit certain uses of the property, or require the property be used for specific purposes only.

Regulations governing how a condominium owner may use his unit and the rights and responsibilities of the common interest development (CID) are typically contained in a declaration of CC&Rs filed with the condominium subdivision plan.

The CC&Rs bind all future owners to comply with the CC&Rs since the use restrictions they contain run with the land.

Chapter 30 Types of tenancies

This chapter discusses the different types of tenancies in real estate and how each is established and managed.

For a further discussion of this topic, see Chapter 9 of Legal Aspects of Real Estate.

Chapter 30 Outline

Tenancies as leasehold estates
Creating fixed-term tenancies
The creation of a periodic tenancy
A tenancy-at-sufferance by any holdover
The tenancy-at-will – consent but no rent
Terminating a tenancy
Changing the type of tenancy
A periodic tenancy due to a defective lease

Chapter 30 Terms

Commencement date	*Personal privilege*
Conveyance	*Primary residence*
Estate-for-years	*Rent-controlled tenancy*
Expiration date	*Reservation agreement*
Fixed-term tenancy	*Residential hotel*
Holdover tenant	*Restraints on alienation*
Lease	*Self-help*
Lease agreement	*Stay*
Leasehold estate	*Tenancy-at-sufferance*
Month-to-month tenancy	*Tenant-at-will*
Periodic tenancy	*Trespasser*

Tenancies as leasehold estates

Tenancies are possessory interests in real estate, called *leasehold estates*.

Four types of tenancies exist:

- Fixed-term tenancies.
- Periodic tenancies.

- Tenancies-at-sufferance.

- Tenancies-at-will.

To initially establish a tenancy, a landlord must **transfer to the tenant** the right to occupy the real estate — a *conveyance* — either in writing, orally or by his conduct. If the landlord does not transfer the right to occupy, the person who takes possession as the occupant is a *trespasser*.

Tenancies other than a tenancy-at-sufferance have an agreed-to termination date or are capable of termination by notice. A *tenancy-at-sufferance* is an unlawful detainer since the tenant's right to occupy has expired, commonly referred to as a *holdover tenant*.

Termination of a **fixed-term tenancy** takes place on the expiration date stated in the lease agreement which conveyed the tenancy and requires no other or further notice.

A **periodic tenancy** conveyed by a month-to-month rental agreement is automatically renewed when the landlord accepts monthly rent. Conversely, a periodic tenancy is terminated on expiration of a properly served notice to vacate, which can be served at any time, or by a 3-day notice to vacate which is served on a breach of the rental agreement. [See Chapter 83 and 84]

Before a landlord can file a UD action, the tenant must be unlawfully detaining the premises. Thus, the tenant's **right to possession** under his tenancy must first be terminated either by service of the proper notice to vacate (quit) or expiration of a lease.

A tenant's possessory interest in real estate can shift from one type of tenancy to another due to:

- a notice;

- expiration of a lease; or

- by conduct.

In our opening example, the tenant traversed three types of **tenancies**:

- *fixed-term* (lease);

- *sufferance* (no agreed-to holdover on termination of his tenancy); and

- *month-to-month* (acceptance of monthly payments), also called a *periodic tenancy*.

The tenant entered into his occupancy under a fixed- term tenancy, a leasehold estate commonly called a *lease*. During the term of the lease, the tenancy can only be terminated and the tenant evicted for cause — and then only after the service of a 3-day notice to cure the breach or vacate (quit) the property. [See **first tuesday** Form 576]

On expiration of a lease, the tenant who remains in possession without agreement or acceptance of rent by the landlord for the continuing occupancy becomes a holdover tenant, legally called a *tenant-at-sufferance*. The landlord does not have to serve a notice to vacate on the holdover tenant before filing a UD action to evict the tenant. [Calif. Code of Civil Procedure §1161(1)]

However, if the landlord accepts rent from a tenant for any period of his continued occupation after expiration of the lease, a periodic tenancy, such as a month-to-month tenancy, is established on the terms and conditions of the expired lease agreement, except for its term of occupancy.

If a renewal or extension option exists, the lease is renewed or extended by the acceptance of rent called for in the option. [Calif. Civil Code §1945]

A landlord who wants to terminate a month-to-month tenancy he created by accepting rent after expiration of a lease must serve the tenant with the proper notice to vacate and let it expire. On expiration of the notice, the tenant who remains in possession of the premises is unlawfully detaining the premises and the landlord may file a UD. Residential landlords must use a notice with the correct 30- or 60-day expiration period to terminate a periodic tenancy, depending on the period of the tenancy, period of the occupancy and location of the property (rent control). [**Colyear** v. **Tobriner** (1936) 7 C2d 735]

Creating fixed-term tenancies

A **fixed-term tenancy**, also known as an *estate for years* or more commonly a *lease*, is the result of an agreement between the landlord and the tenant for a fixed time period. [CC §761]

A lease agreement must have a beginning date, called the *commencement date*, and an ending date, called the *expiration date*. If the rental period is longer than one year, the lease arrangements must be in writing and signed by the landlord and tenant to be enforceable, called a *lease agreement*. [CC §1624]

A **fixed-term tenancy** provides a tenant with several advantages:

- the right to occupy for the fixed term;
- a predetermined rental amount; and
- limitations on termination or modification.

However, some disadvantages also exist for the fixed-term tenant:

- the tenant is liable for the total amount of rent due over the entire term of the lease (subject to the landlord's duty to mitigate losses by locating a replacement tenant); and
- the tenant may not vacate prior to expiration of the leasing period or assign or sublet the premises to a new tenant to cover rent obligations due to prohibitions in the lease against his transfer of possession, called *restraints on alienation*.

The creation of a periodic tenancy

If the landlord finds a fixed-term tenancy too restrictive or inflexible for his financial purposes or use requirements, a periodic tenancy may be more suitable.

A periodic tenancy automatically continues for **successive periods**, each for the same length of time, until terminated by a notice to vacate. The length of each successive period of time is determined by the interval between scheduled rental payments.

Examples of **periodic payment** intervals include:

- annual rental payments, indicating a year-to-year tenancy;
- monthly rental payments, indicating a month-to-month tenancy; and
- weekly rental payments, indicating a week-to-week tenancy.

The flexibility of a periodic tenancy allows the landlord and the tenant to terminate a month-to-month tenancy by giving the appropriate notice to vacate to the other party. [CC §1946; see Chapters 83 and 84]

A tenancy-at-sufferance by any holdover

When a fixed-term (lease) or periodic (month-to-month) tenancy terminates by prior agreement or notice, the tenant who remains in possession — a *tenant-at-sufferance* — unlawfully detains the property from the landlord.

A **tenant-at-sufferance** is more commonly called a *holdover tenant*. A holdover tenant retains possession of the premises without any contractual right to do so, a situation called an *unlawful detainer.*

A holdover tenant no longer owes rent under the expired lease or terminated rental agreement since he no longer has the right to possession. However, the lease or rental agreement usually calls for a penalty rate of daily rent owed for each day the tenant holds over. Without a **holdover rent provision**, the tenant owes the landlord the **reasonable rental value** of the property, a daily rate owed for each day the tenant holds over. [See **first tuesday** Form 550]

Holdover rent is **due after** the tenant vacates or is evicted. It is then that the holdover period is known and the amount owed can be determined, demanded and, if not paid, collected by obtaining a money judgment.

The landlord's acceptance of "holdover" rent **prior** to the tenant vacating or being evicted establishes a periodic tenancy on receipt of the rent.

For example, a tenant with a fixed-term lease holds over after the lease agreement expires. The lease agreement contains no provisions for the amount of rent due during any holdover period.

On the tenant's failure to vacate, the landlord serves the tenant a notice to either pay a rent amount set substantially higher than rental market rates or vacate. The tenant refuses to pay any rent or vacate.

On expiration of the notice, the landlord files a UD action seeking payment of rent at the rate stated in the notice to pay or quit since the tenant did not vacate.

At the UD hearing, the landlord is awarded the reasonable market rental value for the entire time the tenant held over after the lease expired, not the higher rent demanded in the notice to pay or quit.

The higher rental amount demanded in the notice to pay or quit was not accepted by the hold-over tenant since he refused to pay it. Thus, a periodic tenancy was not established to replace the holdover (tenancy-at-sufferance) on expiration of the lease. At all times he was a tenant-at-sufferance in unlawful possession of the property and never agreed to the higher rental amount demanded by the landlord.

A UD court will only award a reasonable rental value for the time period the tenant held over. Also, a notice to (pay or) quit is not needed to evict a tenant on expiration of the lease. [**Shenson** v. **Shenson** (1954) 124 CA2d 747]

The tenancy-at-will – consent but no rent

The characteristics of a **tenancy-at-will** include:

- possession delivered to the tenant with the landlord's knowledge and consent;
- possession for an indefinite and unspecified period; and
- no provision for the payment of rent.

For a tenancy-at-will, a written notice to vacate or pay rent is required to implement any change in the right to occupy the premises. However, the parties can always agree to a shorter or longer notice period. [CC §§789, 1946]

A tenancy-at-will is automatically terminated if the tenant **assigns or sublets** his right to occupy the property to another tenant. The new tenant becomes a tenant-at-sufferance or a trespasser, both are an unlawful detainer and are grounds for eviction without a notice. [**McLeran** v. **Benton** (1887) 73 C 329]

Also, a tenancy-at-will terminates on the **death** of either the landlord or tenant, unless an agreement to the contrary exists. [**Dugand** v. **Magnus** (1930) 107 CA 243]

Other situations giving rise to a tenancy-at-will include:

- when a tenant is granted the right to indefinitely occupy the property in exchange for services rendered [**Covina Manor Inc.** v. **Hatch** (1955) 130 CA2d 290];

- when a tenant takes possession of the property under an unenforceable lease agreement (e.g., a written lease not signed by either party with terms orally agreed to) — unless rent is accepted to create a periodic tenancy [**Psihozios** v. **Humberg** (1947) 80 CA2d 215]; or

- when a tenant is given possession of the property while negotiations on lease provisions regarding the amount of rent are still in progress and rent is not accepted. [**Miller** v. **Smith** (1960) 179 CA2d 114]

Terminating a tenancy

A landlord's primary concern when terminating a tenancy is the type of notice to vacate he must deliver to establish the tenant's unlawful detainer under different **types of tenancies**, including:

- a *fixed-term tenancy*: the landlord does not need to deliver any notice to vacate prior to commencing a UD action against a holdover tenant after expiration of the lease since the tenancy automatically terminates according to the lease terms [CCP §1161(1)]

- a *periodic tenancy*: the notice to vacate must be for a period of at least as long as the interval between scheduled rental payments, but need not exceed 30 days; with the exception of a 60-day notice for residential occupancies which have exceeded 12 months. [CC §1946];

- a *tenancy-at-sufferance*: the landlord is not required to provide a holdover tenant with any further notice prior to commencing eviction proceedings since the lease has expired or a periodic tenancy has been terminated by notice to establish the unlawful detainer of the space [CCP §1161];

- a *tenancy-at-will*: a 30-day notice to vacate or otherwise alter the tenancy-at-will is required [CC §789; see Chapter 81];

- a *rent-controlled tenancy*: termination of the right to possession is restricted by local ordinances; and

- a *tenancy-at-will in a mobile home park*: the tenant must be given a 60-day written notice. [CC §798.55(b)]

Further, a landlord and tenant by agreement can establish a shorter or lengthier notice period, but not less than seven days. Industrial and commercial tenants typically require three months minimum notice due to the time spent receiving and responding to a notice since it must first go through multiple tiers of corporate management. [CC §1946]

Changing the type of tenancy

A landlord, by using an improper notice, may create a different tenancy relationship from the one he initially conveyed to the tenant. When an existing tenancy is altered, in writing or by conduct, the tenancy may have been converted into another type of tenancy.

A classic example involves a change in the type of tenancy which arises when a holdover tenant (a tenancy-at-sufferance) becomes a month-to-month tenant (a periodic tenancy).

A landlord who accepts any rent from a holdover tenant under an expired lease has elected by his conduct to treat the continued occupancy as a periodic tenancy. [**Peter Kiewit Sons Co.** v. **Richmond Redevelopment Agency** (1986) 178 CA3d 435]

Thus, the prerequisite to a UD eviction is the service of a proper notice to vacate on the holdover tenant who paid rent for the continued occupancy, rent the landlord accepted to create a periodic tenancy. [Colyear, *supra*]

If a landlord accepts rent from a holdover tenant after a fixed-term tenancy expires, the expired lease agreement is **renewed** on the same terms except for the period of occupancy, which is now periodic. [CC §1945]

On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments does not renew the tenancy for another term equal to the term of the original lease. Rather, the tenancy is extended as a periodic tenancy for consecutive periods equal to the interval between rent payments — hence, one month if rent is paid monthly. [CC §1945]

A periodic tenancy due to a defective lease

A periodic tenancy arises when:

- a written lease agreement is void or was never signed by either party;
- the tenant is in possession; and
- the landlord has accepted rent.

A tenant who enters into possession under an unenforceable lease agreement and pays rent in monthly intervals is a month-to-month tenant. Either party may terminate the tenancy by delivering a notice to vacate (quit) the premises. [**Kingston** v. **Colburn** (1956) 139 CA2d 623]

Chapter 31 — Leasehold improvements

This chapter covers leasehold improvements made by a tenant and the landlord's rights regarding them on termination of the lease.

For a further discussion of this topic, see Chapter 8 of Legal Aspects of Real Estate.

Chapter 31 Outline

Ownership rights on vacating premises
Leasehold improvement provisions
Failure to make improvements
Improvements promised by the tenant
Landlord's consent to improvements
Permissive improvements by the tenant
Surrender of improvements
Reimbursement for TIs on eviction
Real estate fixtures vs. trade fixtures
Trade fixtures as security
Notice of Nonresponsibility

Chapter 31 Terms

Further-improvements provision	*Real estate fixtures*
Notice of Nonresponsibility	*Tenant Improvements (TIs)*
Permissive improvements	*Trade fixtures*

Ownership rights on vacating premises

A retail business owner enters into a nonresidential lease agreement to occupy commercial space as a tenant. The leased premises does not contain *tenant improvements* (TIs) since the building is nothing more than a shell.

The tenant agrees to make all the **tenant improvements** needed for him to occupy the premises and operate his business (i.e., interior walls, flooring, ceilings, air conditioning, electrical outlets and lighting, plumbing, telephone and electronic wiring, etc.). The tenant will also install trade fixtures on the premises.

The lease agreement provides for the property to be delivered to the landlord on expiration of the lease "in the condition the tenant received it," less normal wear and tear.

However, no other provision in the lease agreement addresses whether tenant improvements will remain with the property or if the property is to be restored to its original condition when the lease expires.

On expiration of the lease, the tenant strips the premises of all improvements he made and vacates. The building is returned to the landlord in the condition it was found by the tenant, an empty shell, less wear and tear. In order to relet the space, the landlord replaces nearly all the tenant improvements that were removed.

Is the tenant liable for the landlord's costs to replace the tenant improvements removed by the tenant on vacating?

Yes! Improvements made by a tenant that are **permanently affixed** to real estate become part of the real estate to which they are attached. Improvements remain with the property on expiration of the tenancy, unless the lease agreement provides for the property to be **restored** to its original condition by removal of tenant improvements. [Calif. Civil Code §1013]

However, the landlord's right to improvements added to the property or paid for by the tenant depends upon:

- the permanent or temporary nature of the tenant improvements (i.e., built-in or free standing); and
- any provisions in the lease agreement relating to the tenant's removal of improvements and restoration of the premises.

Except for **trade fixtures**, improvements attached to the building become part of the real estate. [CC §660]

Examples of **improvements** that become part of the real estate include:

- built-ins (i.e., central air conditioning and heating, cabinets and stairwells);
- fixtures (i.e., electrical and plumbing);
- walls, doors and dropped ceilings; and
- attached flooring (i.e., carpeting, tile or linoleum).

Leasehold improvement provisions

Nonresidential lease agreements typically contain a *further-improvements provision* allowing the landlord to either:

- retain tenant improvements and alterations made by the tenant; or
- require restoration of the property to its original condition on expiration of the lease. [See **first tuesday** Form 552]

Further-improvement provisions usually include clauses stating:

- who will make the improvements (landlord or tenant);
- who will pay for the improvements (landlord or tenant);

- the landlord's consent is required before the tenant makes improvements;
- any mechanic's liens due to improvements contracted by the tenant will be removed;
- the condition of the premises on expiration of the lease; and
- whether the improvements are to remain or be removed on expiration of the lease.

Failure to make improvements

Consider a landlord who, under a lease agreement, obligates himself to make improvements. Once agreed to, the landlord must complete the improvements in a **timely** manner so the tenant may use them or the tenant may cancel the lease agreement. [See **first tuesday** Form 552 §10]

Improvements promised by the tenant

A tenant must complete improvements he has agreed to construct or install on the leased premises. The **time period** for commencement and completion is agreed to in the lease agreement. If not agreed to, a reasonable period of time is allowed. [CC §1657]

However, a tenant may fail to make or complete mandated improvements prior to expiration of the lease. If the improvements are to remain with the property, the tenant is liable to the landlord for the cost the landlord incurs to complete the agreed-to improvements.

Landlord's consent to improvements

Lease provisions often allow a tenant to make improvements to the leased premises. However, further-improvement provisions typically call for the landlord to approve the planned improvements before construction is commenced.

For example, a tenant wishes to add additional space to the premises he leased for use in the operation of his business. The tenant begins construction without the landlord's prior approval as mandated in the lease agreement. Further, the addition is located in space outside the area described as the leased premises in the lease agreement, an encroachment of the tenant's improvements on other land owned by the landlord.

In the past, the landlord had approved tenant improvements. This time, however, the landlord refuses to give consent and complains about the construction the tenant has begun and the encroachment.

The landlord continues to **accept rent** while he negotiates with the tenant regarding the approval of the additional improvements and the modification of the lease agreement to include use of the area subject to the encroachment.

Ultimately, after a few years of negotiations without resolution, the landlord declares a **forfeiture of the lease** based on both the breach of the provision requiring his prior consent to construction and the encroachment of the unapproved improvements.

The tenant now claims the landlord **waived** his right to declare a forfeiture of the lease since the landlord continued to accept the rental payments after the breach of the tenant- improvement provision and encroachment.

However, as long as negotiations to resolve the breach continue, a landlord may accept rent from the tenant without waiving his right to consent to additional improvements. [**Thriftimart, Inc.** v. **Me & Tex** (1981) 123 CA3d 751]

Likewise, a tenant with an option to buy makes improvements with the expectation of ultimately becoming the owner of the property by exercising the option to buy. However, when the lease agreement requires landlord's approval to make the improvements, the landlord's consent is needed before any improvements can be made since the tenant is not yet the fee owner.

Here, the tenant is not entitled to reimbursement for the cost of his improvements, whether or not the landlord consents to the improvements. Further, the improvements will not become the tenant's unless he exercises his option to buy and becomes the owner of the property. [**Whipple** v. **Haberle** (1963) 223 CA2d 477]

Permissive improvements by the tenant

Some lease agreement provisions allow a tenant to make improvements as deemed necessary by the tenant, but do not specifically mandate that he do so or do so in lieu of rent, called *permissive improvements*. Here, the tenant has not obligated himself to make the improvements, but is merely authorized to do so without the need for further consent from the landlord.

Surrender of improvements

All tenant improvements are to remain with the leased property on termination of a lease unless a provision in the lease agreement **permits** or **mandates** their removal by the tenant as a restoration of the premises.

Most lease agreements merely provide for the property to be returned in **good condition**, minus ordinary wear and tear for the years of the tenant's occupancy.

Thus, the tenant is not required to **restore** the property to its actual condition when he took possession since TIs are part of the real estate. A provision calling for **ordinary care** of the premises during the lease does not require the tenant to remove his improvements or renovate the premises to eliminate deterioration, obsolescence and normal wear and tear due to the use permitted to the tenant. [**Kanner** v. **Globe Bottling Co.** (1969) 273 CA2d 559]

Lease provisions calling for **restoration** of the premises to its original condition require the tenant to remove his improvements and restore the property to its original condition, minus any normal deterioration due to the passage of time and use of the premises as permitted. [**Iverson** v. **Spang Industries** (1975) 45 CA3d 303]

If a lease does not require the tenant to **restore the property** to the condition it was in when received, the tenant may only remove his personal improvements, called trade improvements or trade fixtures.

The tenant only needs to leave the property and tenant improvements in good condition. [**Formosa Corp.** v. **Rogers** (1951) 108 CA2d 397]

Reimbursement for TIs on eviction

What compensation may be due to a tenant who has improved the property and is evicted prior to expiration of a lease?

A tenant who is evicted is entitled to the **rental value** of his improvements for the remainder of his unexpired lease term. The tenant is not, however, entitled to reimbursement for the market value or cost of the improvements. Without reimbursement, the landlord receives a windfall profit for his use of the tenant's improvements until they would have reverted to the landlord on expiration of the original lease.

Thus, an evicted tenant is limited to collecting the reasonable value for the landlord's use of the improvements during the remainder of the term on the original lease. [**Asell** v. **Rodrigues** (1973) 32 CA3d 817]

Real estate fixtures vs. trade fixtures

Two types of fixtures exist distinguishing improvements installed on a building located on a parcel of real estate:

- *real estate fixtures*; and
- *trade fixtures*.

A **real estate fixture** is personal property that is **attached** to the real estate. It becomes part of the real estate it is attached to and is conveyed with the property. [CC §§660; 1013]

For example, if a tenant rents an office and builds bookshelves into the wall rather than merely anchoring them to the wall, the bookshelves become part of the improvements located on the real estate.

When the lease expires, real estate fixtures become the landlord's property. The landlord takes possession of the real estate fixtures as part of the real estate forfeited or surrendered to the landlord, unless the lease agreement provides for restoration or permits removal by the tenant. The passage of real estate fixtures from tenant to landlord on expiration of the lease is a conveyance called **reversion**. [**City of Beverly Hills** v. **Albright** (1960) 184 CA2d 562]

Conversely, *trade fixtures* do not revert to the landlord on expiration of the lease. A **trade fixture** is an improvement that is attached to the real estate by the tenant and is unique to the operation of his business, not the use of the building.

Consider a tenant who leases property to operate a beauty salon. The tenant moves in work-related furnishings (i.e., mirrors, salon chairs, wash stations and dryers), necessary to run the business. The items are attached to the floor, walls, plumbing and electrical leads.

On expiration of the lease, the tenant removes the fixtures that were used to render the services offered by the business. The landlord claims the fixtures are improvements to his property and cannot be removed since they became part of the real estate when installed.

However, furnishings unique to the operation of a business are considered trade fixtures even though the furnishings are attached and built into the structure. Trade fixtures are removable by the tenant.

A tenant may, at the end of or anytime during the lease term, remove any fixture used for trade purposes if the removal can be done without damaging the premises. [**Beebe** v. **Richards** (1953) 115 CA2d 589]

Fixtures that have become an integral part of the building's structure due to the way they are attached or the general purpose they serve cannot be removed. Examples of fixtures not used to render services include toilets, air conditioners, vent conduits, sprinkler systems and lowered ceilings. [CC §1019]

Trade fixtures as security

Lease agreements often contain a default provision prohibiting the tenant from removing the trade fixtures when the agreement is breached. The tenant (and his unsecured creditors) no longer have a right to the trade fixtures under a default provision.

However, if the trade fixtures installed by the tenant are owned by a third party, or if a third party had a lien on them at the time of their installation, the landlord has no more right to them than the tenant. [**Goldie** v. **Bauchet Properties** (1975) 15 C3d 307]

Notice of Nonresponsibility

A landlord may find himself paying for improvements made by the tenant if he does not:

- **post** a notice on the premises of his intention to avoid subjecting his property to a lien for the improvements, called a *Notice of Nonresponsibility*; and
- **record** the notice with the county recorder. [See **first tuesday** Form 597]

Tenants occasionally contract for improvements to be constructed on the premises they have leased. Any mechanic's lien by a contractor for nonpayment initially attaches to the tenant's leasehold interest in the property. [CC §3128]

However, the mechanic's lien for unpaid labor and materials may also attach to the **fee simple** interest held by the landlord if:

- the landlord or his property manager earns the construction is taking place; and
- fails to post and record a Notice of Nonresponsibility.

A **Notice of Nonresponsibility** is a written notice that must be:

- posted in a conspicuous place on the premises within ten days after the landlord (or his agent) initially learns of the construction; and
- recorded with the county recorder's office within the same ten-day period. [CC §3094]

A landlord who becomes aware of the construction and fails to post and record the Notice of Nonresponsibility does not become personally liable to the contractor.

Rather, the contractor can only lien the landlord's interest in the real estate and then foreclose on his lien to collect for unpaid labor and materials delivered to improve the property under contract with the tenant. [**Peterson** v. **Freiermuth** (1911) 17 CA 609]

Further, a mechanic's lien can attach to the landlord's interest even when he has posted and recorded a Notice of Nonresponsibility if the lease agreement requires the tenant to make improvement — **mandatory improvements**.

Chapter 32 — Water rights

This chapter presents an overview of the rights of landowners and water producers to remove and use surface and ground water.

For a further discussion of this topic, see Chapter 11 of Legal Aspects of Real Estate.

Chapter 32 Outline

Water is used, not owned
Land entitled to water rights
Riparian rights are appurtenant
Reasonable use and domestic priorities
Water rights are usufructuary
Competing water rights and allotments
Riparian rights not lost by disuse

Chapter 32 Terms

Appropriative rights	*Percolation*
Appurtenant	*Riparian rights*
Correlative rights	*State Water Resources Control Board*
Ground water	*Surface water*
Landowner's rights	*Usufructuary rights*
Overlying rights	

Water is used, not owned

Water is characterized, based on its physical location relative to a parcel of real estate, as belonging in one of two categories:

- *surface water*, consisting of watercourses, lakes, springs, marshes, ponds, sloughs, and any other water flowing over the surface of the earth caused by rain, snow, springs or seepage; or
- *ground water*, consisting of percolating, subterranean bodies of water located in underground *basins*. [Restatement of the Law 2d Torts §§841, 845, 846]

Holders of rights to withdraw **surface waters** are said to have *riparian rights*, and are called *riparian landowners*.

Holders of rights to pump **ground water** are said to have *overlying rights*, and are called *overlying landowners*.

Legal rights to extract and use water are based on priorities and are classified as:

- *landowner's rights* consisting of both riparian and overlying rights;
- *appropriative rights* to withdraw water under license from the state; and
- *prescriptive rights* to withdraw water legally entitled to be used by others.

Riparian rights refer to a landowner's incidental property right, appurtenant to his property, to withdraw water from an adjacent river or lake for beneficial use on his riparian land.

Overlying rights refer to a landowner's right to the use of ground water below the surface of his land. An overlying landowner has rights to an allotment of water which is measured by the ground water in the **basin** over which his land is located. Overlying landowners have equal rights against other overlying landowners to a basin's ground water percolating underneath their land, subject to their *reasonable use* of the water.

Overlying and riparian rights are legally analogous to one another, except for the limitations placed on overlying landowners to use ground water and riparian landowners to use surface water. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

A landowner's use of water in the exercise of his riparian or overlying water rights has *priority* over water rights held by appropriators licensed by the state.

Riparian and overlying water rights are part of the ownership of land, and are *appurtenant* to the land and run with the title to the land when it is sold. Water rights are not personal property which can be assigned or used for the benefit of other property.

Land entitled to water rights

Riparian land is a parcel of real estate located both adjacent to a water source with surface water and within the *watershed* (basin) of the surface water.

The amount of frontage in actual contact with the surface water of a river or lake does not determine whether a parcel is considered riparian land.

A parcel is considered riparian land if it:

- touches the surface water; or
- was part of a larger riparian parcel and retained its riparian rights by reassignment when parceled.

For example, a 40-acre tract of land, of which only 250 feet abuts a stream, is considered riparian land. [**Joeger** v. **Mt. Shasta Power Corp.** (1932) 214 C 630]

To constitute riparian land, a property must also be located within the **watershed** surrounding the watercourse. Should a portion of riparian land extend outside the watershed, only the portion within the watershed is entitled to use the water from the watercourse.

The logic for the watershed rule limiting the use of surface river or lake water to land located within its watershed is that the water will eventually return to the watercourse, minus the water consumed, in a natural process called *percolation*. Additionally, rain falling on lands within the watershed of a watercourse feeds the watercourse. Thus, a riparian land owner can only divert water to the portion of his land which will allow the water through **percolation** to return to the watercourse.

Land lying within the watershed of one stream above the point where the two streams unite, called a *confluence*, is not considered to be riparian to the other. Further, the surface flow (river) **below the confluence** of two streams is a new and entirely different watershed, justifying a new name for the river below the confluence (as is the practice in Mexico to distinguish the watershed). [**Anaheim Union Water Co.** v. **Fuller** (1907) 150 C 327]

Riparian rights are appurtenant

The right to use riparian water is an *appurtenant* (incidental) right which is attached to and transferred with the ownership of real estate. [Calif. Civil Code §§658, 662]

Each riparian landowner is entitled to a *reasonable use* of the natural flow of stream water running through or adjacent to his land. However, the quantity of the water withdrawn is subject to an upstream riparian landowner's **priority** right to *first withdraw* water for reasonable use on his upstream riparian land.

Additionally, a riparian landowner cannot divert stream water to nonriparian lands, even if he is entitled to use the water on his riparian land, but does not, since he is subject to the rules of percolation within the watershed. The landowner's riparian right to use the surface water is appurtenant to the land bordering the stream, not other lands which are not bordering the stream. [**Gould** v. **Eaton** (1897) 117 C 539]

Reasonable use and domestic priorities

Riparian rights are limited by the requirement that water taken from a stream must be put to a **reasonable and beneficial use**. Water is a state resource which, if used under a legal right, must, to the fullest extent possible, be put to reasonable and beneficial use. No one has a protectable interest in the unreasonable use of water. [Calif. Constitution, Article X §2]

Reasonable and beneficial uses include domestic uses and agricultural irrigation. Whether a particular use of water is reasonable and beneficial is determined on a case by case basis. [Calif. Water Code §106]

While riparian landowners hold the same classification of legal rights to water, they must share the water, giving priority to domestic uses over other uses, including agricultural irrigation.

The **sharing** of water between riparian landowners, with priority to upstream owners, is based on a tiered variety of priority and subordinate uses across the entire group of riparian owners, called *correlative rights*. Each landowner holds correlative rights within the riparian class of water rights.

Water rights are usufructuary

Owners of land and water providers (appropriators) who hold water rights do not legally **own** water. Those with legal rights to water only own rights to the **reasonable use** of the water. Their right-to-use is **subject to change** when circumstances controlling the use of water change, called *usufructuary rights*, a sort of "here today, gone tomorrow" approach to access and possession.

If a riparian land owner is not using water, downstream riparian land owners are entitled to the full flow of the water, subject to the upstream riparian owner's future reasonable use. Thus, the lack of use of the appurtenant right to water is not lost by mere nonuse alone.

However, an upstream riparian owner who is not using his **allotment of water** may not divert water to nonriparian land since the water would not percolate into the watershed. The upstream riparian owner's right to use the water is appurtenant to the riparian land and does not include any ownership of the water allowing the landowner to transport the water out of the watershed. [Gould, *supra*]

Competing water rights and allotments

In 1943, California established the **State Water Resources Control Board (Board)**. The Board acts as a referee for all disputes over water rights. As a **referee**, the Board advises the court on the appropriate water allotment each of the disputing parties is entitled to take. Also, on a request from holders of water rights, the board itself may hear legitimate disputes between the parties to determine the water allotment each party is entitled to take. [Wat C §§2000, 2501]

When the Board determines the allotment of water to each holder of riparian rights, the needs of all riparian landowners (within the watershed) are taken into account since riparian rights in water are *correlative*. The amount of water allocated to a riparian owner is determined case by case based on, among other factors, the need for domestic use, irrigation and generating power.

For an example which applies to **correlative rights**, an upstream owner of 66 acres of riparian land suitable for profitable irrigation, a reasonable riparian need, is entitled to a smaller proportion of the water from a watercourse running through his land than a downstream owner of 96 acres of riparian land also suitable for profitable irrigation. [**Half Moon Bay Land Co.** v. **Cowell** (1916) 173 C 543]

Riparian rights not lost by disuse

An owner of riparian land has water rights which are "part and parcel" of his land, called *appurtenant rights*. As an **appurtenant right**, riparian water rights cannot be lost by disuse.

Real estate transactions

Chapter 33 — Types of listings

This chapter identifies the listing agreement as an employment contract and reviews the various types of listing agreements available to the real estate industry, and how to terminate an agency or cancel a listing.

For a further discussion of this topic, see Chapter 8 and 11 of Real Estate Practice.

Chapter 33 Outline

Listings as employment contracts
Employment to act as an agent
Types of listing agreements
Open listings
Cancellation of an open listing
Exclusive listings
Exclusive agency variations
Exclusive right-to-sell listings
Termination of agency by the seller
Documenting the cancellation
Exclusive right-to-buy listings
Net listings
Option listing variation
Guaranteed sale variation

Chapter 33 Terms

Agency relationship
Employment relationship
Exclusive listing
Fiduciary duty
Listing agreement
Net listings
Open listing
Option listing
Unilateral contract

Listings as employment contracts

A *listing agreement* is a written employment contract between a client and a licensed real estate broker. On entering into a **listing agreement**, the broker and his sales staff are *retained and authorized* to perform real estate related services on behalf of the client in exchange for a fee. [Calif. Civil Code §1086(f); see **first tuesday** Form 102 and 103]

The client retaining a broker might hold an ownership interest in real estate, which he seeks to sell, lease or use as collateral to obtain trust deed financing.

Conversely, the client soliciting the services of a broker might be seeking to acquire an interest in real estate as a buyer, tenant or trust deed lender.

The **person employed** by a client to provide real estate services in expectation of compensation will always be a licensed real estate broker. Likewise, if a dispute arises with a client over the client's failure to pay a fee, only the broker employed in a writing (listing) signed by the client may pursue collection.

A real estate agent employed by the broker may have obtained the listing, but the agent did so on behalf of the broker and has no independent right to enforce the listing agreement. An agent's right to a fee arises under the agent's written employment agreement with the broker, not a listing agreement with the client. Through the broker-agent employment agreement, the agent is entitled to a share of the fees actually received by the broker on listings or sales in which the agent participated.

A licensed agent represents a broker as an *agent of the broker*. As the broker's agent, the agent performs on behalf of the broker (as well as the client) all of the activities the broker has been retained by the client to provide. Conversely, an agent providing real estate related services on behalf of a client may not do so independent of his broker. Thus, an agent employed by a broker is referred to as "the agent of the (client's) agent." [CC §2079.13(b)]

The listing agreement sets the **scope of the services** the broker is authorized to undertake while representing the client. Also, the listing authorizes the broker to perform brokerage services and to serve as the client's representative in the negotiation of a real estate transaction.

Further, the listing contains the client's promise to pay a fee, a promise given in exchange for the broker's **promise to use diligence** in his efforts to meet the objectives sought by the client in the employment.

Employment to act as an agent

The relationship created between the client and the broker by a *listing agreement* has two distinct legal aspects:

- an *employment relationship*; and
- an *agency relationship*.

The **employment relationship** established on entering into a listing agreement specifies the **scope of activities** the broker and his agents are to undertake in the employment and authorizes the broker to carry them out.

On the other hand, the **agency relationship** is imposed on the broker by law as arising out of the representation authorized by the employment. Agency carries with it the *fiduciary duties* of loyalty and full disclosure owed by the broker (and his sales agents) **to the client**. [See **first tuesday** Form 305]

Figure 1

first tuesday *Form 104 -*
Loan Broker Listing - Exclusive Right to Borrow

LOAN BROKER LISTING
Exclusive Right to Borrow

Prepared by: Agent ______________________ Phone ____________________
Broker ______________________ Email ____________________

DATE: ____________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

1. **RETAINER COMMITMENTS:**
   1.1 Owner hereby retains and grants to Broker the exclusive right to locate a lender and arrange a loan to be secured by the property described herein, for the period of this listing beginning on ____________, 20______ and terminating on ____________, 20______.
   1.2 Broker to use diligence in the performance of this employment. Owner to cooperate with Broker to meet the objectives of this employment.
   1.3 Owner hands $______________ to Broker for deposit into Broker's trust account for application to Owner's obligations under the attached Listing Package Cost Sheet. [See **ft** Form 107]
2. **ADDENDA to this agreement include:**
   2.1 ☐ Credit Application [See **ft** Form 302]
   2.2 ☐ Loan Purpose Statement [See **ft** Form 328]
   2.3 ☐ Acknowledgement of Changing Conditions [See **ft** Form 203-1]
   2.4 ☐ See Addendum for additional provisions [See **ft** Form 250]
   2.5 ☐ ____
   2.6 ☐ ____
3. **BROKERAGE FEE:**
   NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.
   3.1 Owner agrees to pay Broker __________ of the principal amount of the loan sought or obtained, IF:
      a. Anyone procures a lender on the terms stated in this agreement, or on any other terms accepted by Owner during the period of this listing.
      b. The property is withdrawn as collateral, or title is made unmarketable as collateral by Owner during the retainer period.
      c. Owner terminates this employment of Broker during the retainer period.
      d. Within one year after termination of this agreement, Owner or his agent enter into negotiations, which later result in a transaction contemplated by this agreement, with a lender whom Broker or a cooperating broker negotiated with during the period of this listing. Broker to identify prospective lenders by written notice to the owner within 21 days after termination of this agreement.
   3.2 Should this agreement terminate without Owner becoming obligated to pay Broker a fee, Owner to pay Broker the sum of $______________ per hour of time accounted for by Broker, not to exceed $______________.
4. **LOAN TERMS:**
   4.1 Loan sought is $_____________, payable as follows:
      a. Interest at an annual rate of no more than ______%, ☐ fixed, ☐ ARM type ___________________.
      b. Payments due ☐ monthly, or ☐ ____________, amortized over ______ years.
      c. Final/balloon payment due ____________, 20______.
      d. Late charge ____
      e. Prepayment penalty ____
      f. Loan escrow with ____
      g. A lender's ALTA policy purchased by Owner in the amount of the loan.
      Title Company ____

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5. **REAL ESTATE SECURING THE LOAN:**
   5.1 Type ____
   Address ____
   Referred to as ____
   Vesting ____
   5.2 The priority for the lien securing the loan sought will be ☐ first, or ☐ second.
   5.3 Encumbrances of record:
      a. A first loan in the amount of $______________, payable $______________ per month, until paid, including interest at _____%, ☐ ARM type ____________, due ___________, 20______, impounds being $______________ monthly.
      Lender: ____
      b. A second loan in the amount of $_____________, payable $______________ per month, until paid, including interest at ______%, ☐ ARM type ___________, due ___________________, 20______.
      Lender: ____
      c. Other encumbrance, bond, assessment or lien in the amount of $______________.
      Lienholder ____
   5.4 My purchase price on ______________ was $______________.
   Since the purchase of the property, I have invested in repairs and improvements approximately $______________.
   5.5 The current fair market value is $______________.
   Property taxes for the year 20______ were $______________.
   5.6 The property is occupied by ____
   at a rental rate of $______________ per month, under a:
   ☐ rental agreement; or
   ☐ lease agreement which expires ____________, 20______.
      a. ☐ See attached Rental Income Rent Roll. [See **ft** Form 325]
6. **PERSONAL PROPERTY INCLUDED AS COLLATERAL:**
   6.1 Referred to as:
   6.2 Encumbered for the amount of $____________, payable $____________ monthly, including interest at ______%, due ____________, 20______.
   Lender ____
7. **GENERAL PROVISIONS:**
   7.1 Broker is authorized to disclose, publish, discuss, and disseminate among prospective lenders the financial information supplied by Owner or credit agencies.
   7.2 Owner warrants all necessary permits have been obtained for any additions, alterations, repairs, installations or replacements to the structure or its components, except _________________________.
      a. ☐ See attached Condition of Property Disclosure. [See **ft** Form 304]
   7.3 Owner authorizes Broker to cooperate with other agents and divide with them any compensation due.
   7.4 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

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   7.5 The prevailing party in any action on a dispute shall be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.
   7.6 This listing agreement will be governed by California law.
   7.7 ____

I agree to render services on the terms stated above.	**I agree to employ Broker on the terms stated above.**
	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20______	Date: ____________, 20______
Broker's name: ______________________	Owner's Name: ______________________
Broker's DRE Identification #: ______________	
Agent's name: ______________________	Signature: ______________________
Agent's DRE Identification #: ______________	Owner's Name: ______________________
Signature: ______________________	Signature: ______________________
Address: ______________________	Address: ______________________
Phone: ____________ Cell: ____________	Phone: ____________ Cell: ____________
Fax: ______________________	Fax: ______________________
Email: ______________________	Email: ______________________

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As a **fiduciary**, the broker's conduct and the conduct of his agents under the employment are equated to the conduct required of a trustee acting on behalf of his beneficiary. This fiduciary duty, also called *agency*, survives the termination of the employment relationship. [CC §2079.16]

An oral agreement to perform brokerage services on behalf of a client imposes an agency law obligation on the broker and his agents to act as fiduciaries. In contrast, the client's oral promise to pay a fee does not entitle the broker to enforce collection of the fee due from his client. A fee agreement employing a broker to purchase or sell real estate, lease a property for over one year, or arrange trust deed financing is controlled by the rules of contract law. The fee agreement must be in a writing signed by the client before the broker can enforce his right to collect a fee from the client. [CC §1624(a)(4)]

Types of listing agreements

A variety of listing agreements exist, each employing and authorizing a broker to perform real estate related services under different conditions. The variations usually relate to the extent of the representation and type of services to be performed by the broker and his agents, or the event which triggers payment of a fee. [See **first tuesday** Form 102 and 103; see Figure 1]

Most listing agreements are for the sale or purchase of single family residential property. Others are for residential-income and nonresidential-income properties, such as industrial, motel/hotel, commercial, office, farm or unimproved properties.

Despite the application of various agreements to the type of property listed, all listings fall into one of two general categories:

- *open;* or
- *exclusive*.

Open listings

An **open listing**, sometimes called a *nonexclusive listing*, does not grant exclusive rights to the seller's broker, also known as the *listing broker*, and his agents to be the **sole representative** of the client, be he a buyer, tenant or borrower, or a seller, landlord or lender. The client can enter into open listings with as many brokers as he wants to without becoming obligated to pay more than one fee.

A brokerage fee under an open listing to sell real estate is due a broker only if the broker or his agent *procures* a ready, willing and able buyer and *presents* the owner with an offer from the buyer to purchase the listed property. The terms contained in the offer must be substantially the same as the terms sought by the owner under the listing, called a *full listing offer*, unless other terms offered by a buyer are accepted by the owner.

For a broker to be entitled to a fee under an **open listing**, the broker or his agents must present the offer to the owner before the property is sold to some other buyer located by another broker or by the owner directly. The offer must be submitted before the listing expires or is revoked by withdrawal of the property from sale or by the termination of the agency. [CC §1086(f)(3)]

The broker employed under an open listing is not obligated to use diligence in his efforts to locate a buyer. The broker only has a *best-effort obligation* since the broker does not "accept" the employment until he produces a buyer for the property. Thus, an open listing is legally classified as an *unilateral contract*. However, the **agency duties** of a fiduciary exist at all times under an open listing, and on locating a buyer the broker must commence his due diligence effort to make disclosures and close the transaction.

The first broker to submit an offer during this open listing period from a ready, willing and able buyer to purchase property on the listed terms, or on other terms accepted by the owner, has earned the agreed fee, unless the property has already been sold. None of the other brokers holding open listings from the owner are entitled to a fee.

Also, an open listing allows the owner to market the property himself. Thus, the owner may compete against the listing brokers to locate buyers himself. If he does, the owner does not become obligated to pay a fee under any open listing he may have agreed to.

A broker may also **represent a buyer** to locate property under an open listing agreement. A broker assisting a buyer to locate a suitable property among multiple listing service (MLS) listings held by other brokers should at least consider asking the **buyer to sign** an open listing should the broker be too reticent to solicit an exclusive representation.

An open listing does not need to contain an expiration date, unlike an exclusive agency or exclusive right-to-sell/buy listing which must have an **expiration date**.

Cancellation of an open listing

However, the owner *revoking* an open listing that contains an **expiration date** owes a fee to the broker should the owner personally consummate a sale with a prospective buyer located by the broker during the listing period, or should the owner revoke the listing for the mere purpose of escaping payment of the agreed fee. [**Heffernan** v. **Merrill Estate Co.** (1946) 77 CA2d 106]

Conversely, an open listing without an expiration date may be terminated by the owner at any time without becoming obligated to pay a fee. No fee is due under an open listing for an unlimited time on the *good-faith withdrawal* of the property from the market or on the premature *termination* of the employment before the broker has submitted a full listing offer. [**Tetrick** v. **Sloan** (1959) 170 CA2d 540]

However, an open listing may contain a provision calling for the owner to pay the listing broker a set amount, at an agreed time, for services other than procuring a buyer, such as the preparation of disclosure documents needed by the owner to sell the property.

Exclusive listings

Under the category of **exclusive listings**, a broker receives the **sole right**:

- to represent an owner by marketing the listed property and locating a buyer or tenant; or
- to represent a buyer or tenant by locating property sought by the buyer or tenant.

Exclusive listings require an agent to **use diligence** in his efforts to fulfill his client's objectives to locate a buyer for the property. An exclusive listing must also provide for a **specified period of employment** by including a date for the expiration of the employment, such as 90 or 180 days after its commencement. If an expiration date is not included in an exclusive listing, the broker faces suspension or revocation of his license by the California Department of Real Estate (DRE). [Calif. Business and Professions Code §10176(f)]

Two types of **exclusive employment** agreements exist:

- an *exclusive agency agreement* for a seller or buyer; and
- an *exclusive right-to-sell* or *right-to-buy* listing agreement.

Both types of exclusive listings establish the broker and his agents as the sole licensed real estate representatives of the client (seller or buyer). However, the types are distinguished by whether or not the broker has any right to a fee when the property is sold or located solely by the efforts of the client.

Under the fee provision in an **exclusive agency agreement**, the broker does not earn a fee when the client, acting independently of any other broker or the seller's broker, accomplishes the objective of the employment himself, i.e., selling the listed property or locating and buying the property sought.

Conversely, under the **fee provision** in an exclusive right-to-sell/buy agreement, the broker earns a fee no matter who produces the buyer or locates the property sought under the listing, be it the client, another broker or other representative of the client, or the seller's broker.

Exclusive agency variations

The **exclusive agency listing** is a hybrid of the open and the exclusive listings. The variation is rarely used by brokers as a practical matter and seems best suited to academic discussion.

Under an exclusive agency listing, the client employs the broker as his *sole agent*, as he does in an exclusive type of listing. Also, the broker is entitled to a fee on any transaction in which he, a finder or another agent produces a buyer. (A finder is an unlicensed agent with no authority to negotiate.)

However, under the exclusive agency listing, an **owner retains the right** to sell the property to any buyer he locates without becoming obligated to pay the broker a fee. Likewise for a buyer under an exclusive agency listing who finds the property sought on his own.

As with open listings, brokers are reluctant to spend much time and energy under exclusive agency circumstances. The bottom line is an obstructed brokerage effort with diminished benefits to both the client and broker.

Exclusive right-to-sell listings

An **exclusive right-to-sell listing** affords a real estate broker the greatest fee protection. This type of listing makes the broker the sole agent of the owner to market the property and negoti-

ate with all potential buyers and their agents to sell the property. The broker is entitled to a fee regardless of who procures the buye**r**. Under an exclusive right-to-sell agreement, the owner relinquishes his right to list the property with other agents and to defeat the broker's entitlement to compensation by selling the property himself.

An owner of real estate, on entering into an exclusive right-to-sell listing agreement, grants a broker the **right to locate a buyer** for the property prior to the expiration of the period of employment specified in the listing agreement. The broker is entitled to the agreed-to fee in the listing if, during the listing period:

- the property is sold on any terms, no matter who produced the buyer; or
- the broker or his agent presents the seller with a bona-fide offer from a ready, willing and able buyer on terms sought by the seller under the listing, or on other terms accepted by the seller. [CC §1086(f)(1)]

Exclusive right-to-sell listings give a broker and his agents the greatest incentive to work toward attaining the client's goal of locating a buyer. The seller's broker does not compete with his client to sell the property; they work together to achieve the sale.

Termination of agency by the seller

A seller of real estate enters into an **exclusive listing agreement** with a broker to sell a property within a three-month period. The listing includes a fee provision which contains a *termination-of-agency* clause entitling the broker to a full fee should the seller terminate the broker's employment, without good cause, prior to expiration of the listing period. [See **first tuesday** Form 102 §3.1(c)]

The broker's listing agent promptly commences a diligent marketing effort to properly present the property for sale and locate a buyer who is willing to acquire the property. However, during the listing period and before a buyer is located, the seller terminates the agency by canceling the listing.

The broker makes a demand on the seller for a full listing fee, claiming the termination-of-agency clause in the fee provision of the listing calls for payment of a fee as earned when the seller prematurely terminates the agency. The seller claims the broker is not entitled to a full brokerage fee, but only to money losses based on an accounting for his time, effort and costs incurred to market the property, called *quantum meruit*, since a seller may legally terminate a broker's agency at any time.

Is the broker entitled to collect a full fee from the seller upon the seller's exercise of his legal right to terminate the agency?

Yes! While a seller may terminate the broker's agency at any time, the seller cannot terminate the agency during the listing period and avoid payment of a fee if a **termination-of-agency clause** exists. The termination-of-agency clause in the listing couples the canceling of the listing with the payment of a fee.

Documenting the cancellation

When a seller, by word or by conduct, clearly indicates he no longer desires to sell the property, the agent should prepare a *Release and Cancellation of Employment Agreement* form for the seller to review and sign. [See Form 121 accompanying this chapter]

The **release and cancellation agreement** may call for immediate payment of the full brokerage fee agreed to in the listing in exchange for mutually agreeing to cancel the listing agreement.

Alternatively, it may call for payment at a later date should the property be sold, placed on the market, exchanged, optioned, refinanced (if the broker was retained to arrange new financing) or leased to anyone within a specified time period (for example, one year) after the date of the agreement. A compromise could be the payment of a partial fee with the balance due should the property be sold within the cancellation period.

This release and cancellation agreement is also used when a buyer wants to cancel an *exclusive right-to-buy listing*. On cancellation, the broker is deprived of the opportunity he acquired under the listing to earn a fee. Thus, he has the right to receive compensation.

Exclusive right-to-buy listings

For brokers and their agents, an **exclusive right-to-buy listing** creates a positive and contrasting activity from listing and marketing property. A buyer's listing employs the broker to locate qualified properties to be purchased by a potential buyer the broker exclusively represents.

As with an exclusive right-to-sell listing, the right-to-buy variation provides for a brokerage fee if the buyer acquires property during the listing period of the type sought as described in the buyer's listing.

Also, the exclusive right-to-buy listing provides greater incentive for brokers and their agents and imposes a duty to work **diligently and continuously** to meet their buyers' objectives of locating and purchasing suitable real estate.

The buyer as a client benefits under an exclusive right-to-buy listing due to the greater likelihood the broker will find the particular type of property sought. Brokers have continuous access to all available properties and will investigate and qualify properties as suitable before they are presented to the buyer, and will advise the buyer on the pros and cons of each property presented.

A buyer's broker locating properties listed by other brokers does not become a dual agent or lose his status as the buyer's exclusive agent merely because he works with seller's brokers and his fee is paid by the seller.

A broker who seeks out and locates properties at the request of the buyer negotiates the purchase terms as the **buyer's agent** regardless of who pays the fee, which is nearly always paid by the seller from the proceeds of the sales price paid by the buyer.

RELEASE AND CANCELLATION OF EMPLOYMENT AGREEMENT

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

NOTE: This agreement is used to both terminate a listing employment and eliminate any claims which may have arisen during its existence.

DATE: ____________, 20_____, at ______________________________________, California.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This mutual release and cancellation agreement with waiver of rights pertains to the following employment agreement:

a. ☐ Seller's Listing Agreement [See ft Form 102]
b. ☐ Loan Broker Listing [See ft Form 104]
c. ☐ Exclusive Authorization To Lease [See ft Form 110]
d. ☐ Property Management Agreement [See ft Form 590]
e. ☐ Buyer's Listing Agreement [See ft Form 103]
f. ☐ Trust Deed Listing [See ft Form 112]
g. ☐ Exclusive Authorization To Locate Space [See ft Form 111]
h. ☐ ______________________

1.2 dated ____________, 20______, at ______________________________________, California,

1.3 entered into by ______________________________________, as the Broker, and

1.4 ______________________________________, as the Client,

1.5 regarding property or real estate services referred to as ______________________
______________________________________.

2. AGREEMENT:

2.1 Broker and Client hereby cancel and release each other and their agents from all claims and obligations of any kind, known or unknown, arising out of the employment agreement.

2.2 In consideration of Broker's acceptance of this cancellation, Client to pay Broker a brokerage fee of $______________.

2.3 In consideration of Broker's acceptance of this cancellation, Client to pay the brokerage fee set forth in the employment agreement if Client enters into an agreement for any of the following checked events within ______ months after the date of this cancellation agreement:

a. ☐ The property is sold, exchanged or otherwise transferred.
b. ☐ An option to buy or sell the property is created.
c. ☐ The property is relisted with another broker.
d. ☐ The property is refinanced or further financed.
e. ☐ The property is leased.
f. ☐ The property is acquired.
g. ☐ ______________________________________.

3. WAIVER:

The parties hereby waive any rights provided by Section 1542 of the California Civil Code which states:
"A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

I agree to the terms stated above.
Date: ____________, 20______
Broker: ______________________ DRE #__________

By: ______________________________
Phone: ______________ Cell: ______________

I agree to the terms stated above.
☐ See attached Signature Page Addendum. [ft Form 251]
Date: ____________, 20______

Client's Signature: ______________________

Client's Signature: ______________________
Phone: ______________ Cell: ______________

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Net listings

A **net listing** is used only with sellers, not buyers, and can be structured as either an open or an exclusive type of listing. The net listing has more to do with the way compensation is calculated than with whether it is exclusive or open.

The broker's fee is not predetermined by, or based on, a percentage of the selling price.

Instead, the seller's net sales price, excluding brokerage fees and closing costs, is established in the listing agreement. As his brokerage fee, the broker will receive whatever amount the buyer pays in excess of the seller's net figure and closing costs.

However, the broker must disclose to the seller the full sales price paid by the buyer and the amount of the broker's residual fee before the seller accepts an offer on a net listing. Failure to **disclose the benefits** the broker receives on any transaction leads to the loss of the entire fee. [Bus & P C §10176(g)]

Net listings tend to be unpopular with DRE and consumer protection organizations. They have been outlawed in some states.

By their nature, net listings are particularly prone to claims from buyers and sellers that the broker has been involved in misrepresentations and unfair dealings. These claims are generally based on an improper valuation of the property at the time of the listing or a failure to disclose the fee received by the broker when the property sells.

If the seller thinks the broker's fee is excessive, the seller is likely to complain he was improperly advised about the property's fair market value when employing the broker.

Net listings should be used very sparingly, if at all. If a net listing is used, complete disclosures as to the property's value, the price paid by a buyer and the resulting amount of the fee must occur.

Option listing variation

An **option listing** is normally a variation of the exclusive right-to-sell listing.

Its unique feature is the additional element of a grant to the broker of an **option to buy** the property at a predetermined price, if the property does not sell during the listing period.

The broker wears two hats when holding an option listing: one as an agent, the other as a principal.

The temptation for misrepresentation is quite apparent. The concurrent status of agent and principal is a conflict of interest for the broker. As a result, the seller's broker might fail to market the property aggressively, with a view toward buying it himself and reselling it at a profit. Likewise, the broker might neglect to inform the seller about all inquiries into the listed property.

As always, brokers are required to disclose any outstanding offers or other factors affecting the seller's decision to sell when the broker exercises the option. [**Rattray** v. **Scudder** (1946) 28 C2d 214]

Guaranteed sale variation

A *guaranteed sale listing* is also usually a variation of the exclusive right-to-sell listing. Brokers have been known to use the guarantee feature to boost sales activity during recessionary periods.

A **guaranteed sale listing** is distinct from a regular, exclusive right-to-sell listing in that it is the broker who grants the option to his seller. The **seller** is given the right to call on the broker to buy the property at a predetermined price if the property does not sell during the listing period. In this respect, the guaranteed sale listing establishes a reverse role for the seller from the option listing should the property fail to sell during the listing period.

The difference with the guaranteed sale listing is that the seller, not the broker, has the right to exercise the option by accepting the broker's irrevocable offer (promise) to buy the listed property.

The guaranteed sale variation can be attractive to sellers who, on account of job transfers, sudden unemployment or other financial factors, must sell at all costs. The benefit to the seller is the assurance of a back-up, last-resort sale during recessionary periods of market uncertainty, a risk some brokers are willing to take.

In practice, if a buyer is not produced during the listing period, a desperate seller may have no choice but to sell to the broker since the seller delegated complete control to the broker to locate a buyer.

The broker's advantage, however, is lessened by a DRE regulation which disallows the inclusion of advance fees in a guaranteed sale listing. [Department of Real Estate Regulations §2970(b)(5)]

As always, the broker must disclose all offers and the status of potential offers during the listing period and at the time the seller exercises his option to sell to the broker.

Other listings

Other listing variations contain provisions for the broker to obtain a tenant for a landlord, lease a property for a tenant, arrange a loan on behalf of a borrower who owns real estate or holds a trust deed note, or find a borrower for a lender seeking to make such a loan.

Unimproved real estate, business opportunities and mobile homes can also be the subject of the employment. All of these employment variations can be used with the open or exclusive type of listing agreements.

Chapter 34 Operating under a buyer's listing

This chapter examines the benefits accruing to a buyer and his broker when they enter into an employment agreement authorizing the broker and his agents to act on behalf of the buyer to locate property.

For a further discussion of this topic, see Chapter 15 of Real Estate Practice.

Chapter 34 Outline

A prerequisite to representation
The fee-payment bargain
Get it in writing
Agency duties owed to buyers
Provisions for payment of a fee
Benefits for the listed buyer

Chapter 34 Terms

Bilateral employment agreement	*Special agency duties*
Right-to-buy listing agreement	*Unilateral employment agreement*
Safety clause	

A prerequisite to representation

Most brokers have come to the realization that a signed buyer's listing agreement is the **minimum commitment** necessary from a buyer to produce the maximum financial return for the time, effort and money brokers and their agents invest when assisting buyers as their representative in negotiations.

A buyer's agent need not and should not require a lesser commitment from a buyer than a seller's agent requires from a seller for his services. A buyer's brokers needs to assure himself he will be paid a fee for his services before commencing efforts to locate qualifying properties for a buyer.

To accomplish this level of **financial certainty**, a buyer's broker must enter into a written employment agreement with a prospective buyer, called a *buyer's exclusive right-to-buy listing agreement*. [See **first tuesday** Form 103]

A buyer who refuses to enter into a written listing agreement provides the broker and his agent with a clear understanding that this buyer does not want a representative. What this unlisted buyer wants is someone to act as a **locator** or **finder** of properties without any entitlement to the collection of compensation for the assistance.

An agent who actually assists a buyer who refuses the agent's solicitation to enter into a listing agreement will soon discover the buyer has turned to a friend or relative who is licensed to submit an offer on the property. Alternatively, the buyer may simply submit an offer directly to the seller's agent or seller himself.

Without the buyer's written promise to pay a fee, the buyer's broker will not be entitled to receive a fee should the buyer acquire property by "going around" the broker. No fee has been earned which is collectable from anyone, unless a fee-sharing agreement exists with the seller's broker registering the buyer's name. [See **first tuesday** Form 105]

More importantly, it is unreasonable for a broker and his agent to expect to receive a fee, no matter who is to pay it, for working with a buyer who acquires property located and presented to him by them, unless the broker has been retained under a written employment agreement with the buyer. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

The fee-payment bargain

When an agent solicits employment by a prospective buyer of real estate with the intent of generating fees for his broker, and in turn for himself, various working relationships and compensation arrangements may be struck with the buyer.

Some arrangements for the payment of fees are at best tenuous, especially when the buyer's agent fails to obtain any fee commitment from the buyer, oral or written. Others are astutely built on written promises, signed by the buyer and broker, which call for payment of a fee should the buyer acquire property. Writings, by their nature, are intended by all who enter into them to be enforced, such as a signed buyer's listing calling for payment of a fee when the buyer's objective of acquiring property is met.

Here are several situations which demonstrate the various likelihoods of **collecting a fee** for assisting a buyer:

1. *No listing exists.* Neither the seller nor the buyer have employed a broker. Typically, the real estate involved is other than an owner-occupied residential property. Also, the seller is usually an experienced real estate investor, subdivider, land speculator, REO lender or other well-seasoned owner who is capable of negotiating a real estate transaction without representation.

   The buyer is usually as experienced as the seller, being a builder, developer, syndicator, professional real estate investor or speculator, but may also be an inexperienced buyer of real estate who believes he possesses the business acumen needed to handle the real estate negotiations by himself.

2. *"A one-shot" seller's listing exists.* A buyer is willing to make an offer through the agent who brought a property to the buyer's attention. Both the seller and buyer are typically sophisticated principals.

   Here, the agent fails to ask the buyer to enter into an exclusive right-to-buy listing. Obliquely, the agent solicits and obtains a "one-shot" right-to-sell listing from the seller

before the agent will submit the buyer's offer to the seller. The seller's listing contains a promise to pay a fee. Sometimes the separate fee agreement is the one intended to accompany the offer, which is neither identified nor yet submitted.

3. *Customer turned client.* An agent of a broker with several listed properties is contacted by a prospective buyer. The buyer is exposed to all the "in-house" listings, none of which are suitable or of interest to the buyer. Having exhausted the in-house inventory of listings, the agent can either see the buyer off or make arrangements with the buyer to look into qualifying properties listed by other brokers or into unlisted properties For Sale By Owners (FSBOs), and when located, present them to the buyer.

   If the buyer agrees to allow the agent to locate qualifying properties, the agent must ask the buyer to sign a buyer's listing agreement if his broker is to be assured payment of a fee when the buyer acquires property. If the buyer refuses to enter into a buyer's listing, the agent might still proceed to assist the buyer to locate property.

   Should the buyer later make an offer prepared by the agent, a purchase agreement form must be used which places the fee provision in the body of the buyer's offer if the agent is to protect his fee.

   On failing to obtain a signed listing, the buyer's agent should enter into a fee-sharing arrangement with the listing office for the property specifically naming (registering) the prospective buyer so the time and effort of the buyer's agent is protected should the buyer "go around" the agent and acquire the property. [See **first tuesday** Form 105]

4. *A buyer's listing agreement exists.* An agent's broker is employed in writing under a signed exclusive right-to-buy listing agreement to represent the buyer by locating and negotiating the purchase of suitable property of the type sought by the buyer. [See **first tuesday** Form 103]

   A seller of suitable property may or may not have signed a seller's listing agreement with another broker. Either way, the buyer's broker controls the amount and destiny of the fee he is to be paid when his buyer buys.

Get it in writing

One should sense, on a review of the four basic fee arrangements available to buyer's brokers and their agents, that the lack of a written fee agreement with a buyer when representing the buyer is a failure to exercise prudent judgment in the management of a brokerage business.

Yet many buyer's agents fail to ask their buyer for a written commitment to assure payment of a fee on the buyer's purchase of property. Occasionally, buyer's agents are inexplicably willing to work for a buyer who, when asked, refuses to enter into a buyer's listing agreement. [See **first tuesday** Form 103]

The proper structuring of a provision and documentation of the brokerage fee by a broker and his agent who are already **assisting a prospective buyer** to locate and acquire property is to either:

- **enter** into a written employment agreement with the buyer, called a buyer's listing; then **prepare** a purchase agreement offer on a form which places the fee provision within the terms of the buyer's offer, stating the exact amount of the fee and who will pay it; and **submit** the purchase agreement offer to the seller for acceptance without ever entering into an employment agreement under any type of listing with the seller; or

- if the buyer refuses to sign a buyer's listing agreement, **prepare**, at the earliest opportunity, an offer to buy on a purchase agreement formatted with the fee provision located within the body of the buyer's signed offer; and **submit** the offer without ever entering into a listing agreement with the seller.

Agency duties owed to buyers

The *special agency duties owed* to a buyer when a broker and his agents undertake to locate property on behalf of the buyer first arise when the broker:

- **enters** into an exclusive right-to-buy agreement with the buyer; or

- **presents** property information to an unlisted buyer who they have agreed to assist by locating qualifying properties.

When representing a buyer under a written exclusive right-to-buy employment agreement, the broker (and his agents) have entered into a *bilateral employment agreement*. Such an employment obligates the broker, through his agents, to exercise *due diligence* by way of a constant and continuing search to locate qualifying properties, while keeping the buyer informed of their progress.

Without an exclusive right-to-buy listing, the brokerage duties which exist to locate properties for a buyer are *best-effort obligations* created by an oral (or written) open listing, called a *unilateral employment agreement*. A **best-effort obligation** requires no affirmative action (diligence) on the part of the broker's office to locate property.

However, under a buyer's listing, be it exclusive or open, the act of **delivering property information** to the buyer they are assisting obligates the broker and his agents to use due diligence in their efforts to:

- *gather readily available data* on the property under review;

- *assist in the analysis* of the property data gathered; and

- *advise the buyer* regarding the property and any proposed transaction in a conscientious effort to act honestly, care for and protect the buyer's best interests.

When acting as the buyer's agent regarding the acquisition of a particular property, due diligence includes disclosing facts about the integrity of the property and recommending investigative activity which the agent knows might influence the buyer's conduct in negotiations.

Marketing for new buyers and sellers through technology

Real estate marketing evolves as technology improves. Social networking through the internet has sparked a relatively new approach some agents are using to reach potential clients. From posting pictures and videos of properties on *YouTube* to advertising on *Facebook* and *Myspace*, agents are reaching out to the world's population through the use of the internet.

For agents, one of the most appealing aspects of using social networking websites to conduct business is the fact most are entirely free. This form of free advertising allows agents to keep clients — be they past, present or potential —informed through quick status updates (or "Tweets" if using *Twitter*).

Homebuyers are able to follow the updates of an agent if they so choose, and receive notifications whenever an update is made – effectively allowing those who this technology to reach out to untold numbers of owners, buyers, lenders and tenants, all at once.

Another important aspect of social networking sites to consider is the access it grants to friends, family and acquaintances. If an agent does not solely use his internet page as a means of advertising, but instead uses it as his own personal page, then his family and friends, both past and current, can be plugged-in to the life of the agent, and will be far more prone to contact him or give his name as a reference when they or others need to be represented in the real estate market.

The internet has evolved into a very powerful tool readily at the disposal of all agents and brokers. They can not only advertise and network on these newly available sites, but they can inform their friends and followers about the current status of the real estate market in a more efficient manner. Providing useful, interesting and relevant market information via their tweets and status updates, agents can demonstrate their own authority and prowess.

Without an exclusive employment with a buyer on whose behalf the agent is locating properties, the agent is reduced to a mere "locator" or "finder." Worse yet, the agent is burdened with the affirmative agency duties of utmost care and protection owed the buyer when undertaking a review of data on a property with the unlisted buyer.

Provisions for payment of a fee

An exclusive right-to-buy agreement contains the same operative provisions as are found in exclusive right-to-sell agreements. [See **first tuesday** Form 103]

In exchange for the broker's promise to use *due diligence* while rendering services to comply with his end of the employment bargain, the buyer promises in the exclusive right-to- buy listing agreement to pay the broker a specific fee — either a fixed dollar amount or a percentage of the price paid. The fee is earned when the buyer enters into a binding purchase agreement during the (buyer's) listing period to acquire the type of property described in the buyer's listing.

However, buyers, like sellers, often do not enter into a purchase agreement during the period of employment. Thus, on expiration of the listing, the buyer's broker has not earned a fee. An event triggering payment of the promised fee has not yet occurred.

However, the fee provision of a buyer's listing agreement contains a *safety clause*. The clause provides protection to the broker and his agent after the employment expires from the loss of their time, effort and money "invested" during the employment period to assist the buyer. [See **first tuesday** Form 103 §4.1(c)]

Thus, the broker of the buyer's agent will be entitled to a fee if, within an agreed-to period after the expiration of the buyer's listing:

- information specific to the property was provided to the buyer by the buyer's agent during the listing period;
- on expiration of the buyer's listing, the buyer is handed an itemized list which identifies those properties the buyer's agent brought to the buyer's attention, as required to *perfect* the broker's right to a fee [See **first tuesday** Form 123];
- the buyer entered into negotiations with the owner of a registered property; and
- the safety-period negotiations ultimately resulted in the buyer acquiring an interest in the property.

Benefits for the listed buyer

Like sellers, buyers may resist making a written commitment to exclusively employ one brokerage office as their agent to locate and negotiate the purchase of real estate on their behalf.

However, listed buyers reap benefits unavailable to those buyers who are not exclusively represented by a broker and his agents. Without representation, the unlisted buyer is on his own to conduct a random search among available properties to locate a suitable property.

However, brokers and their agents have access to data which is often not made publicly available to buyers, such as multiple listing service (MLS) printouts, new listings, database searches for qualifying properties, property profiles and comparable sales data provided to brokers and agents by title companies and other brokers.

The activities of a buyer's agent also include approving their buyer with a capable lender and advising the buyer on the location of qualifying properties, the socio-economic mix of neighborhoods, schools and their reputations, local bus lines, religious facilities, zoning, and subdivision and common interest development (CID) restrictions on property usage.

Also, agents attend numerous marketing sessions and trade meetings for the sole purpose of sharing information on listed properties and properties sought by buyers.

All this general information is centrally controlled, channelled and best understood by brokers and agents. It is their business. Thus, when entering into a buyer's listing agreement employing a broker and his agents, a buyer bargains for this insider information to help make decisions which will make the ownership of real estate more viable.

Chapter 35 — The purchase agreement

This chapter covers the use and preparation by an agent of a purchase agreement entered into by buyers and sellers of real estate to document the terms and conditions of their transactions.

For a further discussion of this topic, see Chapter 15 of Real Estate Practice.

Chapter 35 Outline

Types and variations
Analyzing the purchase agreement

Chapter 35 Terms

Equity purchase agreement | *Purchase agreement*
Escrow instructions

Types and variations

A newcomer's entry as a real estate agent into the vocation of soliciting and negotiating real estate transactions typically begins with the marketing and locating of single family residences (SFRs) as seller's and buyer's agents.

However, an agent often branches out and begins handling other types of property and interests.

Other properties the agent may begin handling include one-to-four unit residential properties, apartments and other nonresidential income properties like office buildings, commercial units, industrial space or unimproved parcels of land.

Interests which might be negotiated by the agent include leasehold tenancies when acting as a property manager or leasing agent of the landlord or prospective tenant, or financing arranged as a loan broker for an owner, buyer or tenant.

For sales, the **primary document** used to negotiate the transaction between a buyer and seller is a **purchase agreement form**. As different types of properties exist, so too do different types of purchase agreements exist, each with the provisions necessary to negotiate the sale of that particular type of property.

Three basic categories of purchase agreements exist for the documentation of real estate sales. The categories are influenced primarily by legislation and court decisions addressing the handling of the disclosures and due diligence investigations in the marketing of properties. The three **categories of purchase agreements** are for:

- one-to-four unit residential property sales transactions;

- other than one-to-four unit residential property sales transactions, such as for residential and nonresidential income properties and owner-occupied business/farming properties; and
- land acquisition transactions.

Within each category of purchase agreements, several variations exist. The variations cater to the specialized use of some properties, the diverse arrangements for payment of the price, and to the specific conditions which affect a property, particularly within the one-to-four unit residential property category.

For example, purchase agreement variations for **one-to-four unit residential sales** transactions include purchase agreements for:

- negotiating the conventional financing of the purchase price [See Figure 1, **first tuesday** Form 150];
- negotiating a short sale [See **first tuesday** Form 150-1];
- negotiating a cash to new or existing loan, or a seller carryback note [See **first tuesday** Form 150-2];
- negotiating for separate brokerage fees paid each broker by their client [See **first tuesday** Form 151];
- negotiating the government insured financing (FHA/VA) of the purchase price [See **first tuesday** Forms 152 and 153];
- negotiating the sale of an owner-occupied residence-in-foreclosure to an investor, called an *equity purchase agreement* [See **first tuesday** Form 156];
- negotiating an equity purchase short sale [See **first tuesday** Form 156-1];
- direct negotiations between principals (buyers and sellers) without either party being represented by a real estate agent [See **first tuesday** Form 157]; and
- negotiating highly specialized transactions using a "short-form" purchase agreement which does not contain boilerplate provisions setting forth the terms for payment of the price, which allows the agent to attach specialty addenda to set the terms for payment (a carryback ARM, equity sharing addenda, etc.). [See **first tuesday** Forms 155-1 and 155-2]

Variations among purchase agreements used in **income property** and **owner-occupied business property** sales transactions include purchase agreements for:

- the conventional financing of the purchase price [See **first tuesday** Form 159]; and
- the downpayment note financing of the purchase price. [See **first tuesday** Form 154]

Figure 1

first tuesday *Form 150 -*
Purchase Agreement - One-to-Four Residential Units - Conventional and Carryback Financing

PURCHASE AGREEMENT
(One-to-Four Residential Units — Conventional and Carryback Financing)

Prepared by: Agent ____________ **Phone** ____________
Broker ____________ **Email** ____________

DATE: ________, 20____, at ______________________, California.
Items left blank or unchecked are not applicable.
FACTS:
1. Received from ______________________, as the Buyer(s),
1.1 the sum of $________, evidenced by ☐ personal check, or ☐ ____________,
payable to ______________________, for deposit only on acceptance of this offer.
1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
1.3 situated in the City of ____________, County of ____________, California,
1.4 referred to as ______________________,
1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]
2. This agreement is comprised of this five-page form and ____ pages of addenda/attachments.
TERMS: Buyer to pay the purchase price as follows:
3. Cash payment through escrow, including deposits, in the amount of . . . . $________
3.1 Other consideration paid through escrow ______________ . . . $________
4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . $________
payable approximately $________ monthly for a period of ____ years.
Interest on closing not to exceed ____%, ☐ ARM, type ____________.
Loan points not to exceed ________.
4.1 ☐ Unless Buyer, within ____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]
5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ______________ with an unpaid principal balance of . . . . $________
payable $________ monthly, including interest not exceeding ____%,
☐ ARM, type ____________, plus a monthly tax/insurance impound payment of $________. ______________
5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.
6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ______________ with an unpaid principal balance of . . . $________
payable $________ monthly, including interest not exceeding ____%,
☐ ARM, type ____________, due ________, 20 ____.
7. Assume an improvement bond lien with an unpaid principal balance of . . . . $________
8. Note for the balance of the purchase price in the amount of. . . . . $________
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $________ monthly, or more, beginning one month after closing, including interest at ____% per annum from closing, due ________ years after closing.
8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ________.
8.2 Financial Disclosure Statement is attached as an addendum. [See **ft** Form 300]
8.3 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]
8.5 Within ____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.
8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]
8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]
9. Total Purchase Price is . . . . $________

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Scan this QR-Code for a PDF of the Form!

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10. ACCEPTANCE AND PERFORMANCE:
10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within ____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.
10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.
10.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.
10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as ______________________.
10.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **ft** Form 183]
10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **ft** Forms 171 or 172]
10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.
10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $________, or ☐ the deposit receipted in Section 1.

11. PROPERTY CONDITIONS:
11.1 Seller to furnish prior to closing:
a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.
b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.
c. ☐ a one-year home warranty policy:
Insurer ______________________
Coverage ______________________
d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.
e. ☐ a certification by a licensed contractor stating the sewage disposal system is functioning properly, and if it contains a septic tank, is not in need of pumping.
f. ☐ a certification by a licensed water testing lab stating the well supplying the property meets potable water standards.
g. ☐ a certification by a licensed well-drilling contractor stating the well supplying the property produces a minimum of ____ gallon(s) per minute.
h. ☐ Energy Audit Report stating the rating for the property's improvements is no greater than ____.
I. ☐ ______________________
11.2 Seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **ft** Form 304]
a. ☐ is attached; or
b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may either cancel the transaction based on a reasonable disapproval of the disclosure or deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance. [See **ft** Form 269] Seller to repair, replace or correct noticed defects prior to closing.
c. On Seller's failure to repair, replace or correct noticed defects under §11.2b or §11.4a, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See **ft** Form 183]
11.3 Seller's Transfer Fee Disclosure Statement [See **ft** Form 304-2]
a. ☐ is attached; or
b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Withing ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Transfer Fee Disclosure.
c. Seller to pay any transfer fees arising out of the transaction.
11.4 Buyer to inspect the property twice:
a. An **initial property inspection** is required on acceptance to confirm the property's condition is substantially the same as observed by Buyer and represented by Seller or Seller's Agents prior to acceptance, and if not substantially the same, Buyer to promptly notify Seller in writing of undisclosed material defects discovered. [See **ft** Form 269] Seller to repair, replace or correct noticed defects prior to closing; and

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Figure 1, Continued

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b. A **final walk-through inspection** is required within five days before closing to confirm the correction of any noticed defects under §11.2b and §11.4a and maintenance under §11.14. [See **ft** Form 270]

11.5 Seller's Natural Hazard Disclosure Statement (NHD) [See **ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of Buyer's post-acceptance receipt of the NHD, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to Buyer prior to acceptance. [See **ft** Form 182 and 183]

11.6 Buyer acknowledges receipt of a booklet and related Seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978 one-to-four units) [See **ft** Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960 one-to-four units). [See **ft** Form 315]

11.7 The property is located in: ☐ an industrial use area, ☐ a military ordnance area, ☐ a rent control area, ☐ airport, farmland, San Francisco Bay or mining operation area, see attached Notice Addendum [See **ft** Form 308] or ☐ ______________________________

11.8 On acceptance, Seller to hand Buyer the following property operating information:

a. ☐ Property Expense Report for Buyer's review within ten days of receipt; Buyer may terminate the agreement during the review period based on a reasonable disapproval of the information received. [See **ft** Form 306]

b. ☐ See attached Leasing and Operating Addendum for additional conditions. [See **ft** Form 275]

11.9 If a Homeowners' Association (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed, copies of the association's: 1) Articles of Incorporation, 2) CC&Rs, 3) Bylaws, 4) operating rules, 5) age restriction statement, 6) operating budget or summary, including reserve study, 7) assessment and reserve funding disclosure statement, 8) CPA's financial review, 9) assessment enforcement policy, 10) insurance policy summary, 11) regular assessment, 12) special assessment, 13) emergency assessment, 14) other unpaid obligations of seller, 15) approved changes to assessments, 16) settlement notice regarding common area defects, 17) preliminary list of defects, 18) notice(s) of violation, 19) required statement of fees, 20) minutes of regular meeting of the board of directors conducted over the previous 12 months, 21) transfer fee.

a. Association claims for property defects or changes in regular or special assessments ☐ are or ☐ are not pending or anticipated. Current monthly assessment is $_______________.

b. Seller is not in violation of CC&Rs, except ______________________________.

c. Seller to pay association document and transfer fees. [See **ft** Form 135]

d. Buyer to approve the association's statement of condition of assessments and confirm representations in subsection 11.9a above as a condition for closing escrow.

e. Within ten days of Buyer's post-acceptance receipt of the association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See **ft** Form 183]

11.10 Seller's Neighborhood Security Disclosure [See **ft** Form 321]

a. ☐ is attached, or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

11.11 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

11.12 If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

11.13 Possession of the property and keys/access codes to be delivered: ☐ on close of escrow, or ☐ as stated in the attached Occupancy Agreement. [See **ft** Forms 271 and 272]

11.14 Seller to maintain the property in good condition until possession is delivered.

11.15 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

11.16 Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

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— — — — — PAGE FOUR OF FIVE — FORM 150 — — — — —

12. CLOSING CONDITIONS:

12.1 This transaction to be escrowed with ______________________________.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **ft** Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **ft** Form 401]

12.2 Escrow to be handed all instruments needed to close escrow on or before ____________, 20______, or within ______ days after acceptance. Parties to hand Escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **ft** Forms 310 and 311]

12.3 Buyer's title to be subject to covenants, conditions, restrictions, reservations and easements of record. ______________________________.

12.4 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by ______________________ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements ______________________________

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

12.5 Buyer to furnish a new fire insurance policy covering the property.

12.6 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

12.7 Bill of Sale to be executed for any personal property being transferred.

12.8 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **ft** Form 183]

13. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

14. NOTICE REGARDING GAS AND HAZARDOUS LIQUID PIPELINES:

This notice is being provided simply to inform you that information about the general location of gas and hazardous liquid transmission pipelines is available to the public via the National Pipeline Mapping System (NPMS) Internet Web site maintained by the United States Department of Transportation at http://www.npms.phmsa.dot.gov/. To seek further information about possible transmission pipelines near the property, you may contact your local gas utility or other pipeline operators in the area. Contact information for pipeline operators is searchable by ZIP Code and county on the NPMS Internet Web site.

15. BROKERAGE FEE:

15.1 Parties to pay the below mentioned Broker(s) a fee now due of ______________________ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

15.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee ________:_________.

15.3 Attached is the Agency Law Disclosure. [See **ft** Form 305]

15.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

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— — — — — PAGE FIVE OF FIVE — FORM 150 — — — — —

16. ______________________________

Buyer's/ Selling Broker: ____________	Seller's/ Listing Broker: ____________
Broker's DRE Identification #: ____________	Broker's DRE Identification #: ____________
Selling Agent: ____________	Listing Agent: ____________
Agent's DRE Identification #: ____________	Agent's DRE Identification #: ____________
Signature: ____________	Signature: ____________
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: ____________	Address: ____________
Phone: ____________Cell:____________	Phone: ____________Cell:____________
Fax: ____________	Fax: ____________
Email: ____________	Email: ____________
I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [**ft** Form 251]	☐ See Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20______	Date: ____________, 20______
Buyer: ____________	Seller: ____________
Signature: ____________	Signature: ____________
Buyer: ____________	Seller: ____________
Signature: ____________	Signature: ____________

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.

Date: ____________, 20______

Name: ______________________________

Signature: ______________________________

Name: ______________________________

Signature: ______________________________

FORM 150 08-12

Finally, a variation exists for land sales of a parcel of real estate which has no improvements in the form of buildings. [See **first tuesday** Form 158]

Escrow instructions provide yet another variation on the purchase agreement. A buyer and seller who have entered into escrow instructions without first entering into a real estate purchase agreement are bound by the escrow instructions as though it was a purchase agreement. [See **first tuesday** Form 401]

Attached to all these various purchase agreements are one or more **addenda**, regarding:

- disclosures about the property;
- the financing of the price paid for the property;
- agency relationship law; and
- special provisions called for by the needs of the buyer or seller.

However, the focus here is limited to the needs of the newly licensed agent who will be negotiating single family real estate sales. Thus, this chapter discusses the purchase agreement used in SFR sales transactions structured for the conventional financing of the purchase price.

Analyzing the purchase agreement

The conventional purchase agreement, **first tuesday** Form 150, is used to prepare and submit the buyer's **written offer** to purchase one-to-four unit residential property. Terms for payment of the price are limited to conventional financing, an assumption of existing loans and a carry-back note. Form 150 is also properly used by sellers in a counteroffer situation to submit their **fresh offer** to sell the real estate.

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms must be complete and clear to prevent misunderstandings so the agreement can be judicially enforced.

Thus, Form 150 is a comprehensive "boilerplate" purchase agreement which serves as a **checklist**, presenting the various conventional financing arrangements and conditions a prudent buyer would consider when making an offer to purchase.

Each section in Form 150 has a separate purpose and need for enforcement. The sections include:

1. *Identification:* The date of preparation for referencing the agreement, the name of the buyer, the amount of the good-faith deposit, the description of the real estate, an inventory of any personal property included in the transfer and the number of pages contained in the agreement and its addenda are set forth in sections 1 and 2 to establish the facts on which the agreement is negotiated.
2. *Price and terms*: All the typical variations for payment of the price by conventional purchase-assist financing or an assumption of existing financing are set forth in sections 3

through 9 as a checklist of provisions. On making an offer (or counteroffer), the terms for payment and financing of the price are selected by checking boxes and filling blanks in the desired provisions.

3. *Acceptance and performance:* Aspects of the formation of a contract, excuses for non-performance and termination of the agreement are provided for in section 10, such as the time period for acceptance of the offer, the broker's authorization to extend performance deadlines, the financing of the price as a closing contingency, procedures for cancellation of the agreement, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract.
4. *Property Conditions:* The buyer's confirmation of the physical condition of the property as disclosed prior to acceptance is **confirmed** as set forth in section 11 by the seller's delivery of reports, warranty policies, certifications, disclosure statements, an environmental, lead-based paint and earthquake safety booklet, any operating cost and income statements, and any homeowners' association (HOA) documents not handed to the buyer prior to entry into the purchase agreement, as well as by the buyer's initial inspection, personally or by a home inspector, and final inspection at closing to confirm the seller has eliminated defects known, but not disclosed, prior to acceptance.
5. *Closing conditions:* The escrow holder, escrow instruction arrangements and the date of closing are established in section 12, as are title conditions, title insurance, hazard insurance, prorates and loan adjustments.
6. *Notice of supplemental property tax:* Notifies the buyer he will receive one or two supplemental property tax bills he is to pay when the county assessor revalues the property after a change in ownership, as set forth in section 13.
7. *Notice regarding gas and hazardous liquid pipeline:* Notifies the buyer that information about the general location of gas and hazardous liquid transmission pipelines is available via the *National Pipeline Mapping System (NPMS)* web site, and that further information about possible pipelines near the property may be obtained from the local gas utility or other pipeline operators in the area, as set forth in section 14.
8. *Brokerage and agency:* The release of sales data on the transaction to trade associations is authorized, the brokerage fee is set and the delivery of the agency law disclosure to both buyer and seller is provided for as set forth in section 15, as well as the confirmation of the agency undertaken by the brokers and their agents on behalf of one or both parties to the agreement.
9. *Signatures:* The seller and buyer bind each other to perform as agreed in the purchase agreement by signing and dating their signatures to establish the date of offer and acceptance.

Chapter 36 — The appraisal report

This chapter reviews the appraisal process preceding a sale and discusses the valuation methods used by an agent or broker to set an appropriate price for a property.

Chapter 36 Outline

Chapter 36 Terms

Appraisal report	*Key lot*
Appraiser	*Net operating income (NOI)*
Capitalization approach	*Present worth*
Comparative market approach	*Principle of change*
Corner lot:	*Principle of conformity*
Cost approach	*Principle of contribution*
Cul-de-sac lot	*Principle of progression*
Depreciation	*Principle of regression*
Fair market value (FMV)	*Principle of substitution*
Flag lot	*Principle of supply and demand*
Interior lot	*T-intersection lot*

What is an opinion of value?

An appraisal is an individual's **opinion** or **estimate** of a property's value on a specific date written, reduced to writing in an *appraisal report*.

The **appraisal report** contains data collected and analyzed by the appraiser about the property in question which substantiates the appraiser's opinion of value. The value of a parcel of real estate, given in a dollar amount, is the *present worth* to buyers of the future benefits arising out of ownership of the property.

Factors used in the appraisal process to determine a **property's value** include:

- **utility** – the property's possible uses;
- **scarcity** – the availability of similar properties;
- **demand** – the number of buyers for the property;
- **transferability** – the seller's ability to transfer good title to a buyer without encumbrances defined in a title insurance policy;
- **physical considerations** – the property's proximity to commercial amenities, access to transportation, the availability of freeways, beaches, lakes, hills, etc;
- **social considerations**;
- **economic considerations** – rents in the area, vacancies and the percentage of homeownership; and
- **political considerations** – property taxes, zoning and building codes.

Conversely, the present owner's original acquisition cost, mortgage financing and equity are not factors used to determine a property's value.

There are many different types of values assigned to a property. In real estate appraisal, the most common type of value used is *market value*, also called *fair market value (FMV)*.

The **fair market value** of a property is the highest price on the date of valuation a willing seller and buyer would agree to, both having full knowledge of the property's various uses. [Calif. Code of Civil Procedures §1263.320]

Economic principles in appraisal

Several economic concepts are used in the appraisal of real estate. These principles are referred to as *principals of appraisal* and include:

1. The *principle of supply and demand*: For appraisal purposes, the principle of supply and demand holds that once the supply of land decreases, the value of land increases since more people are competing for the remaining land. This principle correlates to the density of the population.

2. The *principle of change*: The principle of change holds that property is constantly in a state of change. The change a property goes through is seen in its *life-cycle.* The **life-cycle** of a property has three stages: *development, maturity* and *old age*.

   Development of the property includes the subdivision of lots, improvements constructed and the start of a neighborhood community.

   The **maturity stage** of a property, such as a home within the community, starts when the homes become older and the children grow up and move out of the community.

   The **old age stage** starts when the oldest buildings begin to deteriorate, lower social or economic groups move into the community and larger homes are converted into multiple family use.

3. The *principle of conformity*: The principle of conformity holds that when building similarity is maintained in a neighborhood, the maximum value of a property can be obtained. Zoning regulations and conditions, covenants and restrictions (CC&Rs) attempt to protect homeowners by restricting the use and excluding nonconforming uses of the property.

4. The *principle of contribution*: The principle of contribution holds that the value of one component (improvement) is measured in terms of its contribution to the value of the whole property. For example, a property's market value may not increase if additions, such as a swimming pool, are added.

5. The *principle of substitution*: The principle of substitution holds that a buyer will not pay more for a property if it will cost less to buy a similar property of equal desirability.

6. The *principle of regression*: The principle of regression holds that the value of the best property in a neighborhood will be adversely affected by the value of other properties in the neighborhood. For example, this principle applies to over-improved homes. When an owner makes extensive renovations, such as adding a swimming pool and rooms and landscaping, and the other neighbors do not, the house is no longer as similar to the others. On the sale of the over-improved home, the owner will not receive the full value of the cost of improvements he has made.

7. The *principle of progression*: The principle of progression is the opposite of the principle of regression, holding that a smaller and lesser maintained property in a well-kept neighborhood will sell for more than if the home were in an area of comparable properties.

Steps in the appraisal process

The appraisal process consists of four steps:

1. Identifying and defining the appraisal effort to be undertaken by the appraiser;
2. Data collection;
3. Applying the data; and

4. Determining the value of the property.

Defining the appraisal effort

The first step in the appraisal process is the identification of the questions to be answered during the appraisal.

The questions to be answered include:

- What is the purpose of the appraisal?
- What interest in the property is being appraised?
- What is the description and location of the property to be appraised?
- Who owns or holds an interest in the property being appraised?
- What is the highest and best use of the property in light of zoning and CC&Rs?
- What encumbrances affect the condition of title to the property?
- Are there any facts that the appraiser must clarify?
- What is the appraiser's fee?

Gathering data

The background information gathered on the property to conduct an appraisal is divided into two categories:

1. *General data*: Information on the region, city and neighborhood surrounding the property; and
2. *Specific data*: Includes the location, lot and improvements.

The **general data** gathered are to provide an overview of the property. Data on the local and regional economy are included since it affects property within the local real estate market. Regional considerations include geography. Also, a growing city or county where jobs are available is desirable. Other features to consider include the quality of school systems and public facilities.

The collection of **specific data** about a property includes information on the size of the parcel, the improvements on it and the uses permitted.

Lot types include:

1. **Cul-de-sac lot**: a lot facing the rounded turn-around portion of a dead-end street. A cul-de-sac property is private since it is not subject to through traffic. Unlike rectangular lots, the cul-de-sac lot has a small front yard which is offset by a larger backyard.

2. **Corner lot**: a lot located at the intersection of two streets. A corner lot does not have a great deal of privacy due to traffic on the streets it intersects. However, the corner lot may be more desirable since access to the sideyard and backyard for vehicles is available from the side street.

3. **Key lot**: a lot bordered by more than three lots on the sides and the back by other lots facing the front of another street. The biggest disadvantage of the key lot is the lack of privacy due to numerous neighbors abutting the sides of the lot.

4. **T-intersection lot**: a lot at the end of a dead-end street. The biggest disadvantage of the T-intersection lot is noise and lack of privacy.

5. **Interior lot**: a lot surrounded by lots on all three sides. This is the most common type of lot. An interior lot is usually rectangular in shape with a large backyard. However, privacy is limited since the lot is adjoined on all sides by neighbors.

6. **Flag lot**: a lot located behind other lots with a long and narrow access driveway to a public street. Flag lots tend to offer a lot of privacy and better views in hilly areas.

The physical aspects of a lot include:

- size and shape;
- slope, drainage and soil;
- view, exposure to sun and weather; and
- improvements.

Applying the data

The third step in the appraisal process is applying the data collected using one of the three appraisal methods, which are:

1. The *comparative market approach* (market data method);
2. The *cost approach* (replacement method); and
3. The *capitalization approach* (income method).

Market comparison approach

The **market comparison** method is the most commonly used to establish the fair market value of the interest appraised in the real estate. Applying the market comparison approach, the ap-

praiser looks at the current selling prices of *similar properties* to help establish the comparable value of the property appraised. Adjustments are made for any differences in the similar properties, such as their location, obsolescence, lot size and condition of the properties.

For example, a property owner's neighbor recently sold his residence for $245,000. The neighbor's house is of a similar age, size and condition as the owner's house, except it has a fireplace worth $3,000 which the owner does not have. Adjusting for the difference in the improvements (the fireplace) between the owner's and neighbor's house would establish the value of the owner's house at $242,000.

To produce a more reliable appraisal, it is better to gather data on as many comparable sales, frequently abbreviated as "*comps*," as are available, then compare the similarities of each of them against the property being appraised. Sales information can be obtained from the multiple listing service (MLS), tax records, electronic databases on recordings and title insurance companies.

Now consider an owner of real estate who seeks to reduce the assessed value set on his property by the county assessor since property values have dropped measurably during the past year.

To justify his evaluation, the assessor uses the comparable sales approach to set the property's assessed value, but makes no adjustments for the age, size, location or quality of the sales **comps** before determining the value of the owner's similar property.

The owner claims the basis provided by the assessor to justify his appraisal of the property's value was improper since the assessor failed to make any adjustments to the value of comparable properties when applying the comparable sales method to set the value of his property.

Here, the value set by the assessor's appraisal was *legally incompetent* and thus improper. The assessor failed to make adjustments in the value of comparable properties which are required when using the comparable sales method to set the value of the owner's similar but different property. [**Mitchell** v. **County of Los Angeles** (1997) 60 CA4th 497]

Cost approach

Appraisers setting value using the **cost approach** calculate the construction cost to replace the improvements from scratch. From the replacement cost appraisers subtract their estimate of the accrued **depreciation** of the existing improvements due to *obsolescence* and *deterioration* to get the current replacement value of the improvements. Added to this is the value of the parcel as though it was vacant. Thus, the appraised market value under the cost approach is the result of totaling the value of the lot plus the cost to replace the improvements minus the depreciation of the building.

The cost approach is best used when valuing **new buildings** and **special** or **unique structures**. Examples of special or unique structures include churches and factories.

Also, an appraiser uses the cost approach when recent comparable sales are not available or the property has no income.

Estimating the cost of improvements which would be incurred today to construct the improvements as they exist on the property involves the calculation of *direct* and *indirect costs*.

Direct costs include labor and materials used to construct the improvements.

Indirect costs include expenditures other than labor and materials, including permits and other governmental fees, insurance, taxes, administrative costs and financing charges.

The steps to forming an appraisal using the cost approach include:

- estimating the value of the land, by use of the market comparison approach;
- estimating the replacement cost of the building as if it were new;
- estimating the physical depreciation of the existing improvements due to obsolescence and deterioration; and
- adding the value of the lot and the replacement cost of a new building adjusted for the estimated depreciation for the existing building.

The estimated replacement cost of the existing improvements is determined using one of three methods:

- **comparative-unit method**: estimates the cost in terms of dollars per square foot or per cubic foot based on known costs of similar structures, adjusted for physical differences;
- **unit-in-place method**: estimates the unit costs for building components such as foundations, floors, walls, windows and roofs, as well as labor and overhead; and
- **quantity survey method**: the most comprehensive and accurate method estimates the cost of the labor and materials a general contractor would use to build an identical structure, such as lumber, cement, plumbing, electrical, roofing, stucco, glazing, drywall, insulation and labor costs.

After the appraiser estimates the replacement costs, the next step is to estimate and deduct depreciation.

Depreciation reflects any value-related loss in the property due to use, decay and improvements that have become outdated. There are three types of depreciation:

1. **Physical deterioration** is the loss in the property's value due to wear and tear. Physical deterioration can be curable or incurable. Examples include damage from termites and damage resulting from deferred maintenance and negligent care.
2. **Functional obsolescence** is any loss in the property's value due to outdated style or non-usable space. Examples include antique fixtures, a one-car garage or an outdated kitchen.

3. **Economic obsolescence** is the loss in property value due to changes in the property's neighborhood. Economic obsolescence is external to the property. For example, a property's value may decrease due to increased noise and traffic if a freeway is built next to it.

The last step is to subtract any depreciation of improvements from the replacement cost.

The capitalization approach

The **capitalization approach**, also known as the *income approach*, determines the property's value based on future income and operating expenses of the property. Property appraised using the income approach includes apartments, offices, industrial buildings, commercial units and other income-producing property.

The first step to establish value using the income approach is to determine the property's *effective gross income*. A property's effective gross income is its gross income minus vacancies and collection losses. [See **first tuesday** Form 352]

The second step is to deduct **operating expenses** from the effective gross income to determine the property's *net operating income* (NOI). Operating expenses include such items as property taxes, insurance, security, management fees, utilities and maintenance. Operating expenses that vary, such as utilities and repairs, are called *variable costs*. Operating costs that remain constant, such as property taxes, management, security services and insurance, are called *fixed costs*.

The third step is to divide the property's NOI by the appropriate *capitalization rate* (cap rate). The **capitalization rate** is comprised of the investor's expected annual rate of return on his total cost paid to acquire the property and a *rate of recovery* of his acquisition costs allocated to the improvements, also called *depreciation*.

Finally, the market value of the property is determined by dividing the NOI by the capitalization rate. For example, if a property's NOI is $100,000 annually, and a capitalization rate of 10% is used, the property's value under the income approach would be $1,000,000.

The rate of interest paid on mortgages and the amount or terms of mortgage debt on a property have no bearing on a property's market value. The property is viewed as being clear of any monetary encumbrances.

Correlation of values

The final step in the appraisal process is the *correlation of the values* arrived at under each of the three methods described previously. The process selects the most appropriate value from the values arrived at by using the three methods.

The appraisal report

The *appraisal report* is the documentation of the appraiser's findings. The types of appraisal reports include:

- short form – a filled-in form using checks and explanations;

- letter form – a brief written report; and
- narrative report – an extensive written report.

The following information needs to be included in the appraisal report:

- the property's description;
- the purpose and scope of the appraisal;
- description of the neighborhood;
- the date on which the value is estimated;
- qualifying conditions and assumptions;
- factual date, photos and maps with analyses;
- the processing of the date (bracketing);
- the estimate of value;
- the name, address, type of license and signature of the appraiser.

Appraiser's duty of care to lender

An owner of real estate employs an appraiser to prepare an appraisal. The appraisal overstates the square footage of the property and fails to report the lack of permits for various improvements on the property. A private lender makes a second trust deed loan on the owner's property based on the appraisal.

Later, the owner defaults and the lender's junior trust deed is wiped out by the foreclosure sale under the prior mortgage lien.

The lender makes a demand on the appraiser for the lost investment in the second trust deed note claiming the appraiser negligently overestimated the market value of the property in his appraisal.

The appraiser claims he does not owe a duty of care to the lender since the owner, not the third party lender, employed him as an appraiser.

Here, the appraiser owes a duty of care to the lender and thus is liable for the lender's loss of his trust deed investment since the valuation was negligently set by the appraiser. The lender is a member of a class of persons for whom an appraisal is made and thus may rely on the appraisal. [**Robert H. Sorosky M.D. Defined Benefit Pension Plan** v. **Hamill** (1996) 48 CA4th 1590]

Now consider a loan broker arranging a loan for a private money lender who hires an appraiser to determine the value of real estate.

The appraiser hands the broker his written appraisal report which overestimates the value of the property. The broker in turn hands the appraisal report to his private lender. The lender, relying on the report, funds a loan arranged by the broker and secured by a trust deed on the property.

The owner defaults and the lender incurs a loss due to the insufficient value of the property.

Here, the appraiser is liable for the private lender's losses since the appraiser owed a duty of care to potential lenders who may rely on the appraisal report to justify funding a trust deed loan, even though the report was prepared for the loan broker. [**Soderberg** v. **McKinney** (1996) 44 CA4th 1760]

Appraiser licensing

All appraisers are required to hold a license or certification issued by the offices of the supervisor of appraisers in the state of California.

The license/certification categories are:

- **Trainee appraiser** – allows the trainee to work on the appraisal of properties under the direct supervision of an appraiser licensed to appraise those properties. To obtain a trainee license, a minimum of 150 hours of appraisal education is required. As part of the education requirement, the trainee licensee must complete the 15-hour National Uniform Standards of Professional Appraisal Practice (USPAP) course taught by an Appraisal Qualification Board (AQB) certified instructor.

- **Residential appraiser** – allows the appraisal of one-to-four residential units up to $1 million and nonresidential property up to $250,000. To obtain a residential license, the licensee must have 2,000 hours encompassing 12 months of experience, plus 150 hours of appraisal education including the 15-hour USPAP appraisal practice course.

- **Certified residential appraiser** – allows the appraisal of residential properties of any dollar amount and nonresidential property up to $250,000. A certified residential license requires 2,500 hours encompassing at least 30 months of experience, plus 200 hours of appraisal education including the 15-hour USPAP appraisal practice course. An Associate Degree or 21 credits in an appraisal related subject is also required.

- **Certified general appraiser** – allows the appraisal of any type of real estate and transaction value or complexity. A certified general license requires 3,000 hours of experience encompassing 30 months of experience, during which 1,500 hours is on nonresidential properties. Also required is 300 hours of appraisal education including the 15-hour USPAP appraisal practice course. A Bachelor's Degree or 30 semester credits in an appraisal related course is also required.

Proof of completion of a seven-hour *National USPAP Update Course* is required every two years as continuing education. A total of 56 hours of continuing education, including the USPAP Update Course, is required every four years and must be evidenced with each renewal application.

Justifying the buyer's price is another matter

When a buyer locates a property and contracts to pay a price to buy it, the property must be qualified as *collateral* providing adequate security for the repayment of the loan amount.

This task of valuation falls to **third-parties** in the transaction, parties that are always directly or indirectly hired by the lender, not the buyer who is paying for it. However, the buyer has an even greater interest in knowing he has paid the right price than the lender, but is unable to contact or discuss that subjective evaluation and the price he his paying with the third-party, the *appraiser.*

The appraisal to set the *fair market value* (FMV) of a property must be conducted in accordance with strict data gathering and reporting guidelines set for real estate appraisers. The subjective end result of the report, which is in the form of a dollar amount, is another matter.

Under ideal appraisal rules for setting a property's value:

- the appraiser's connection with the lender will be severed;
- the independence of the appraiser will be honored; and
- the method for developing the current market value of the property is legislated to respect the **lesser evaluation** generated by the different methods for setting a property's FMV.

Seller's brokers and sellers will not be happy with the initial impact of an appraisal report on a buyer, since the buyer's price and terms of purchase will no longer be the standard for setting the property's value or the acceptable condition of that property. The history of comparable sales, costs of replacement by construction and current rental values will keep property values from drifting upward quickly enough to attract speculators.

Appraisals are reflective of past events; historical reports since they are not forward-looking. A factor based on the current rate of inflation may well be allowed as the only increase in value over the value set by the appraiser.

Appraisals under federal law

It is unlawful to violate appraisal independence, including:

- coercing, extorting, colluding with, instructing, bribing or intimidating any appraisal professional into appraising property at a value based on any factor other than the independent judgment of the appraiser;

- mischaracterizing the appraised value of a property to secure a loan;
- influencing or encouraging an appraiser to meet a targeted value for a property; and
- withholding or threatening to withhold payment for an appraisal report or service. [15 United States Code 1631 §129E]

This does not prohibit anyone with an interest in the transaction from asking an appraiser to:

- consider **additional relevant property information**, including information regarding comparable properties;
- provide **further explanation** for the valuation;
- **correct errors** in the appraisal report;
- provide a copy of the **sales contract** with purchase transaction.
- obtain **multiple valuations** in order to assure reliability in value assessment; or
- **withhold compensation** due to breach of contract or inferior service.

No appraiser or appraisal company may have an interest, financial or otherwise, in the property being appraised.

If a lender is aware of a violation of appraisal independence, they are prohibited from using that appraisal report to make a loan, unless the lender has confirmed that the appraisal does not misrepresent the value of the property.

Lenders and their agents must compensate *fee appraisers* at a rate that is reasonable in the market area of the property being appraised. A fee appraiser may charge a fee for complex assignments that reflects the increased time, difficulty and scope of the work performed.

Any violation of the above regulations by a mortgage loan broker (MLB) when arranging or originating a Real Estate Settlement Procedures Act (RESPA) loan will result in a civil penalty assessed by the Fed of no more than $10,000 for each day the violation continues. Any subsequent violation with result in a civil penalty of no more than $20,000 for each day the violation continues.

Chapter 37 — Escrow, the time for performance

This chapter discusses the purpose of an escrow to ensure that the expectations of the parties and terms of the transaction are met.

Chapter 37 Terms

Bilateral escrow instructions	*Performance*
Closing	*Prorations*
Escrow company	*Settlement*
Escrow officer	*Unilateral escrow instructions*
Good faith dispute	

The execution of a purchase agreement

Escrow is a process employed to **facilitate the closing** of a transfer of real estate between two parties, typically under a primary agreement, e.g., a *purchase agreement*. [Calif. Financial Code §17003(a)]

In mortgage transactions, *escrow* references the duty of the lender to receive funds from the property owner for the payment of the property taxes and insurance premiums (TI) of the property securing the mortgage. Typically, these funds are collected monthly with the regular principal and interest (PI) payment.

The funds accumulate and are disbursed by the lender. Collectively, the mortgage principal, interest, property taxes and insurance premiums are referred to as *PITI*.

Escrow activity consists of:

- *one person*, such as a seller or buyer of real estate, who delivers written documents or money, called *instruments*, to an escrow company for the purpose of fully performing his **obligations owed another person** under an agreement entered into prior to opening the escrow for a sale, encumbrancing or leasing of real estate; and

- *the escrow company*, who **delivers** the documents and money **to another person**, such as the buyer, seller or third parties, on the occurrence of an identified event or the performance of prescribed conditions, such as the receipt of reports or the issuance of a title insurance policy. [Fin C §17003(a); Calif. Civil Code §1624]

An individual engaged in the business of acting as an **escrow agent**, called an *escrow officer*, must be licensed and employed by a corporation, called the *escrow company.* The **escrow company** must also be licensed by the California Department of Corporations, unless *exempt*. [Fin C §17200]

Individuals exempt from the escrow licensing requirements include:

- a *licensed real estate broker,* either individual or corporate, who represents a person in a real estate transaction (sale, mortgage or lease) in which the broker will perform **escrow services**;

- a *licensed attorney* who is not actively engaged in conducting (holding himself out as) an escrow agent;

- a *bank*, trust company, savings and loan association (thrift) or insurance company; and

- a *title insurance company* whose principal business is preparing abstracts or making searches of title used for issuing title insurance policies. [Fin C §17006]

The **services rendered** by escrow agents typically include:

- receiving funds and collecting necessary documents, such as appraisal reports, disclosure statements and title reports called for in the *escrow instructions*;

- preparing documents necessary for conveyancing, encumbrancing and evidencing the creation of debts required for escrow to close;

- calculating prorations and adjustments; and

- disbursing funds and transferring documents when all conditions for their release have been met. [Fin C §17003(a)]

However, the specific duties of the escrow officer, outlined in the **escrow instructions**, vary according to local real estate custom.

Escrow basics

Consider a buyer and seller who enter into a purchase agreement for the sale of the seller's one-to-four unit residence. As provided in the **purchase agreement**, escrow needs to be *opened* to handle the closing of the transaction, called *performance* by the buyer and seller.

In modern real estate practice, **opening escrow** simply means establishing a depository – the escrow – for the **instruments** (deed, money and other items) with accompanying escrow instructions. Escrow instructions are signed by all necessary persons (the buyer and seller in the case of a sale) to authorize escrow to transfer or hand those instruments to the other person or others on closing. [**Montgomery** v. **Bank of America National Trust & Savings Association** (1948) 85 CA2d 550]

Before accepting any instruments as an escrow holder for a transaction, the escrow officer will need to receive *dictated instructions* by an agent of the buyer or seller regarding precisely when and under what circumstances the documents and monies deposited with escrow are to change hands. The escrow officer notes all the tasks to be undertaken to manage and close escrow by preparing a *"take sheet"* before drafting escrow instructions.

Increasingly, agents simply email a copy of the purchase agreement to the named escrow company. The escrow officer then drafts escrow instructions from the purchase agreement provisions and sends the instructions to the real estate agent to verify they conform to the intent of the persons in the transaction.

Any number of details (preparation, receipt and transfer of monies and documents) must be attended to by the escrow officer before the transaction can be completed, called a *closing* or *settlement*. [**Shreeves** v. **Pearson** (1924) 149 C 699]

As a checklist for "going to escrow," a worksheet helps the seller's agent to organize the collection of facts and supporting papers the escrow officer will need to immediately draw instructions, clear conditions and close escrow. [See **first tuesday** Form 403]

Escrow instructions

The escrow officer will perform only as instructed. **Escrow instructions** are prepared by the escrow officer based on the information received from the seller's agent about the transaction. [**Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847; see **first tuesday** Form 401]

In practice, the escrow officer prepares the instructions on forms they have adopted for this use, forwarding them to the agents of the persons in the transaction for their signatures and return to escrow. When returned, escrow is then **open** for the person who signed and returned the instructions.

Two types of escrow instructions are used in California: *bilateral* and *unilateral instructions*.

In Southern California, escrow instructions prepared by escrow officers are usually **bilateral** and prepared when escrow is opened. Bilateral escrow instructions are given to escrow by the buyer and seller jointly, each signing a copy of the same instructions. [See **first tuesday** Form 401]

Separate **unilateral escrow instructions** provide separate instructions to the buyer and seller. Each set of instructions contain only the activities to be performed by or on behalf of one person, the buyer's instructions or the seller's instructions. In Northern California, escrow instructions are occasionally unilateral and prepared at the time of closing, after escrow determines it has all documents necessary to call for funding and closing.

The documents work together

Most modern real estate sales transactions depend on both the purchase agreement and the escrow instructions working in tandem to close a transaction.

Both the purchase agreement and the escrow instructions are *contracts* regarding interests in real estate. To be enforceable under the *Statute of Frauds*, both documents must be **in writing**. [CC §1624; Calif. Code of Civil Procedure §1971]

A **purchase agreement** sets forth the sales price and terms of payment, together with conditions to be met before closing.

Escrow instructions constitute an additional agreement between the buyer and seller which is entered into with an escrow company, but **do not replace the purchase agreement**. Escrow instructions are merely directives which an escrow officer undertakes to coordinate a closing under the terms of the purchase agreement on behalf of the buyer and the seller. [**Claussen** v. **First American Title Guaranty Co.** (1986) 186 CA3d 429]

However, escrow instructions occasionally add exactness and completeness, providing the enforceability sometimes lacking in purchase agreements prepared by brokers or their agents.

Generally, the purchase agreement is the primary underlying document in a real estate sales transaction and is considered the original contract. All further agreements, including the escrow instructions, must comply with the primary document, unless **intended to modify** the terms of that original agreement.

The agents negotiating a transaction, and their brokers, are responsible for ensuring the escrow instructions, whether prepared or dictated by them or others, **conform to the purchase agreement**. They do this by reviewing the instructions prepared by the escrow officer to ensure the intentions of the buyer and seller are clear. The escrow instructions should be reviewed by the agents prior to submitting them to their clients for additional review and signatures.

In some instances, the buyer and seller orally negotiate the sale and go directly to escrow, without first reducing their agreement to writing. Thus, they do not enter into an underlying written purchase agreement prior to opening escrow. Here, the buyer and seller intend the escrow instructions to function as the **binding contract** documenting the sale, in addition to simply

providing closing instructions. In this situation, the escrow instructions constitute a binding contract between the buyer and seller which satisfy the **Statute of Frauds** should either need to enforce the agreement. [**Amen** v. **Merced County Title Co.** (1962) 58 C2d 528]

Escrow checklist ensures a timely closing

To provide for a smooth, timely closing, the agent dictating instructions needs to collect and hand to the escrow officer all of the information necessary to prepare the instructions and documents. Some agents leave the job of tracking down documents and information to the escrow officer, limiting the agent's involvement to simply forwarding a copy of the purchase agreement to the named escrow company. To enhance the likelihood of a successful and timely closing, the agent should have a **checklist** of items and information to gather for the escrow officer. [See **first tuesday** Form 403]

Leaving it up to the escrow officer to glean from the purchase agreement the needs for closing without the supplemental information known to the agent imprudently stresses the escrow officer and threatens a timely closing.

Of note, an escrow officer does not have an obligation to notify the buyer or seller of any suspicious fact or circumstance detected by the officer before the close of escrow, unless the **fact affects closing**. However, an agent best serves his client by selecting escrow officers who properly alert the agent to potential problems outside the escrow instructions which are known to the escrow officer. [**Lee** v. **Title Insurance and Trust Company** (1968) 264 CA2d 160]

To avoid confusion when dictating instructions, the broker must consider the type of transaction (sale, loan, exchange or lease) being escrowed, timelines for the elimination of any contingencies and the final date scheduled for the close of escrow.

If the escrow instructions are vague or incomplete on any point, the underlying purchase agreement must be analyzed by the agents and their clients before dictating amended instructions.

Modifying escrow instructions

If the point in dispute is not addressed in the underlying purchase agreement or controlled by local real estate custom, then it is not part of the contract. Any such contested item must be added to the escrow instructions by amendment, if agreeable to both the seller and buyer. These amended instructions supersede the prior contract and bind the buyer and seller to the terms agreed to in the instructions. [**U.S. Hertz, Inc.** v. **Niobrara Farms** (1974) 41 CA3d 68]

Naturally, amended instructions adding terms which are modifications of the purchase agreement prudently state that they modify the purchase agreement.

Escrow instructions which **modify** the intentions stated or implied in the purchase agreement must be **written, signed and returned** to escrow by the buyer and seller. Proposed modifications signed by some but not all parties are **not binding on a party** who has not agreed to the modifications. [**Louisan** v. **Vohanan** (1981) 117 CA3d 258]

Before closing escrow, an agent may discover an aspect of the escrow instructions which conflict with the intentions expressed in the purchase agreement or the expectations of the buyer or seller. The agent is duty-bound to immediately bring these discrepancies to the attention of the escrow officer and his client. [**Claussen** v. **First American Title Guaranty Co.** (1986) 186 CA3d 429]

On notification of an error in the instructions or a need for clarification, the escrow officer must hold up the close of escrow until the discrepancy is clarified and corrected escrow instructions have been prepared, signed by the buyer and seller, and returned to escrow. [**Diaz** v. **United California Bank** (1977) 71 CA3d 161]

Changes in the escrow instructions and purchase agreement should be prepared by escrow as *amended escrow instructions* for the buyer and seller to sign. Neither person may individually modify the terms of the escrow instructions without the knowledge and consent of the other person. [**Smith** v. **Brown** (1934) 1 CA2d 492]

The **amended instructions** should reference the purchase agreement as being modified. Once the buyer and seller agree on the terms, the escrow can proceed toward closing.

The purchase agreement and escrow instructions work together to ensure that the original expectations of the buyer and seller at the time of contracting are met when the transaction closes. The careful agent reviews the provisions of both documents to ensure no conflicts exist, and that the intentions of the parties will be fully performed by all concerned. [See **first tuesday** Form 150 and 401]

Required escrow disclosures

All written escrow instructions signed by a buyer or seller **must contain a statement**, in not less than 10-point type, which includes the licensee's name and the name of the state department issuing the license or granting the authority under which the person conducting the escrow is operating. [CC §1057.7; see **first tuesday** Form 401]

In addition, all escrow transactions for the purchase of real estate where a **policy of title insurance will not be issued** to the buyer must include an **advisory notice** prepared in a separate document and signed by the buyer. The notice must state:

> "IMPORTANT: IN A PURCHASE OR EXCHANGE OF REAL PROPERTY, IT MAY BE ADVISABLE TO OBTAIN TITLE INSURANCE IN CONNECTION WITH THE CLOSE OF ESCROW SINCE THERE MAY BE PRIOR RECORDED LIENS AND ENCUMBRANCES WHICH AFFECT YOUR INTEREST IN THE PROPERTY BEING ACQUIRED. A NEW POLICY OF TITLE INSURANCE SHOULD BE OBTAINED IN ORDER TO ENSURE YOUR INTEREST IN THE PROPERTY THAT YOU ARE ACQUIRING." [CC §1057.6; see **first tuesday** Form 401-1]

Finally, escrow has a duty to advise the buyer in writing of the *Franchise Tax Board (FTB)* requirements for withholding 3 1/3% of the price paid the seller, unless the seller certifies he is exempt from state income tax withholding. [Calif. Revenue and Taxation Code §18662(e)(3)(B)]

Prorations

On the close of escrow, buyers and sellers receive a credit or a charge for their proportionate share of income or expenses, called *prorations*.

Prorations are usually divided based on the date escrow closes, but can be any date agreed on by the buyer and seller. The entire day of closing is the first day of the buyer's ownership, unless the escrow instructions specify otherwise.

Items which the buyer takes over and are prorated include:

- property taxes;
- interest on loans/bonds assumed;
- rent; and
- service contracts assumed by the buyer.

Prorations are initially agreed to in the purchase agreement. Proration provisions entitle the seller to a credit for the portion of prepaid sums which have not accrued on the day of closing on items the buyer takes over or receives on the sale.

Conversely, the buyer receives a credit for unpaid amounts assumed by the buyer which accrued through the day prior to the close of escrow. [See **first tuesday** Form 150 §12.6]

Property taxes are levied for the fiscal year of July 1st to June 30th of the following calendar year. To prorate property taxes, the beginning of the fiscal year is the starting point for accrual. Prorations are based on a 30-day month or a 360-day year.

Property taxes are paid in one or two installments. The first installment is payable no later than December 10th for the first half of the fiscal year. The second payment is due no later than April 10th for the second half of the fiscal year.

A buyer might also assume an existing **fire insurance policy**. When the seller prepays an insurance premium on a policy assigned to the buyer, the seller receives a credit and the buyer is charged for the amount of the premium for the period beginning with the date escrow closes. [**Greco** v. **Oregon Mutual Fire Insurance Company** (1961) 191 CA2d 674]

For **interest** on loans, improvement bonds or other debts assumed by the buyer, the seller is charged and the buyer receives a credit for the interest accrued and unpaid during the seller's ownership of the property through the day before the close of escrow.

On the purchase of income property, the buyer is entitled to a credit for the **prepaid rents** collected by the seller which have not accrued for the remaining days of the month beginning with the day of the close of escrow.

All **security deposits** held by the seller are credited to the buyer as a lump sum adjustment, not a proration, since, after closing, the buyer is responsible to account to the tenants for the deposits on termination of their tenancies. [See **first tuesday** Form 585]

The seller is credited for any delinquent unpaid rents which have accrued prior to closing and are to be collected by the buyer.

Estimating loan balances

The seller's broker preparing a seller's *net sheet* for his client initially makes a *good faith estimate* of the existing **loan balance**. When the buyer assumes the loan, the estimate of the loan balance will also be entered by the buyer's agent when preparing the buyer's cost sheet, the purchase agreement and escrow instructions for the transaction. [See **first tuesday** Form 310 and 311]

The broker must explain to his client (or others he may be assisting) that the down payment, carryback note or purchase price (as agreed to in the purchase agreement adjustment provisions) will vary to the extent the loan balance estimates vary from the actual loan balance at the time of closing. The close of escrow can be jeopardized by surprises if the adjustments are not understood by the buyer and seller up front.

Disputed funds held in escrow

A buyer's *good faith deposit* toward the payment of the purchase price of a one-to-four unit residential property must be returned within 30 days after the person entitled to the funds demands them. When escrow fails to close, the issue becomes who has the right to receive any funds deposited in escrow by the buyer. [CC §1057.3]

A seller or buyer who wrongfully refuses to release the buyer's good faith escrow deposit is liable for a money penalty of three times the amount wrongfully withheld, called *treble damages*. **Treble damages** must be greater than $100 but less than $1,000, plus attorney's fees (which can run into the tens of thousands). [CC §1057.3]

Even when a *forfeiture-of-deposit* provision is included in a purchase agreement and initialed by all, the seller is not entitled to any of the buyer's funds unless he has suffered **out-of-pocket money losses** due to the buyer's breach of the purchase agreement or escrow instructions.

Thus, the seller must release the escrowed deposit to the breaching buyer, less any out-of-pocket money losses the seller actually incurred due to the buyer's breach. Unless escrow receives mutual instructions to disburse the funds held in escrow when escrow fails to close, the escrow company will deposit the funds with the court, relieving itself of any further responsibility to account for the funds, called an *interpleader*.

Thus, escrow can close out its trust account on this escrow file. [CCP §386; **Security Trust & Savings Bank** v. **Carlsen** (1928) 205 C 309]

Good faith dispute over deposits

Release of the funds is not required if a legitimate *good faith dispute* exists between the buyer and the seller over entitlement to the funds. [CC §1057.3(f)(2)]

Neither the buyer nor seller will be entitled to any penalty or statutory attorney's fees on resolution of a **good faith dispute**.

The good faith standard for an individual's refusal to release escrowed funds requires a *reasonable belief* by the individual of his right to the funds. [CC §1057.3(c)]

Adjacent Owner Issues

Chapter 38 Boundary disputes

This chapter applies the agreed-boundary doctrine as a method of settling boundary disputes.

For a further discussion of this topic, see Chapter 13 of Legal Aspects of Real Estate.

Chapter 38 Outline

Doctrine of agreed boundaries
Elements of the ancient doctrine
Agreeing to the boundary
Uncertain boundaries
Agreement to make certain
The element of duration
Marking the line
Limitations of the doctrine

Chapter 38 Terms

Agreed-boundary doctrine
Common boundary
Express agreements
Lot line adjustment
Statute of limitations

Doctrine of agreed boundaries

A parcel of real estate is divided into two equally sized parcels by a recorded survey. Later, a fence is erected between the two that is not located on the common boundary line. Thus, one parcel appears to be physically larger than the other.

The owner of the parcel which appears smaller (that has the fence located on it within its boundary) sells his parcel. The new owner hires a surveyor to determine the location of the boundary between the properties.

The survey sets the boundary at the location described in recorded documents. The survey shows the fence is not located on the legally described boundary between the adjacent properties.

The owner of the smaller parcel seeks to recover possession of the strip of land located on the other side of the fence, within his legal description, by removing the fence.

The neighboring owner of the larger parcel claims the fence is the agreed boundary since the fence has stood for so many years that it is reasonable to infer the previous owners agreed the location of the fence to be their **common boundary.**

The owner of the smaller parcel claims the *agreed-boundary doctrine* does not apply since a recorded legal description of the boundary is available and the true boundary can be located.

Is the owner of the smaller parcel correct in relying on the legal description of the property to establish the actual boundary location?

Yes! The doctrine of title by agreed boundaries, commonly referred to as the **agreed-boundary doctrine**, does not apply since:

- the exact boundary location can be readily located; and
- the owner of the larger parcel defending the fence as the boundary cannot show the prior owners were **uncertain** as to the true boundary description and then, to resolve their uncertainties of location, **agreed** the fence would mark the boundary. [**Bryant** v. **Blevins** (1994) 9 C4th 47]

Elements of the ancient doctrine

To establish a boundary line under the *agreed-boundary doctrine*, the following facts must exist:

- **uncertainty** as to the boundary's exact location;
- an **agreement** between the owners to set the boundary line; and
- **acquiescence** to the boundary line for a period of at least five years; or
- a **substantial loss** would be suffered due to a change in the location of the boundary line to the legally described location. [**Ernie** v. **Trinity Lutheran Church** (1959) 51 C2d 702]

The **agreed-boundary doctrine** developed during a time when less advanced surveying techniques, or lack of surveyors or monuments, made it too difficult or expensive to locate the boundary line described in the deeds.

Thus, the more practical way to set a boundary line in rural and relatively unpopulated areas with lower land values was often for owners of adjacent parcels to agree between themselves on the location of a common marker, such as a fence, to set the agreed boundary.

However, surveying techniques have significantly improved. Now, if a deed is clear and a competent surveyor is available, the true boundary line can easily be established to eliminate the uncertainty of the boundary's location. Thus, the ancient agreed-boundary doctrine has been reduced to the status of a legal last resort.

In the absence of an oral or written agreement between an owner and his neighbor to set the boundary line at some place other than a well-surveyed and documented deed line, the boundary line described in their deeds remains as the boundary. [**Armitage** v. **Decker** (1990) 218 CA3d 887]

Agreeing to the boundary

Once owners of adjacent properties uncertain over the true boundary actually agree to establish the location of their common lot line, the location they set will replace the legal line, regardless of how inaccurate it is, provided either the five-year statute of limitations runs or substantial loss would result from the boundary line being moved to the legally described location.

For example, two neighbors own adjacent parcels of real estate and each farm their respective parcels.

When their real estate was originally surveyed decades earlier, the federal government placed a five-inch section post to mark the boundary line. The neighbors search but cannot locate the section post to help them set their property lines. Instead of surveying their parcels, they mutually erect a fence intending it to set the boundary between their properties.

The fence is eventually taken down, but the owners continue to farm up to the spot where the fence had been located.

Over five years later, each owner sells their respective property to different buyers. The new buyers continue to farm their parcels within the parameters set by the original owners.

Later, one of the new owners surveys his parcel, locates the federally placed post and marks the legally described property line. The location of the post reveals the owner's neighbor has been farming 2½ acres on his side of the property line described in the public records.

The owner sues to quiet title to the 2½ acres and reclaim possession. The neighbor claims the fence line became the boundary line when the original owners set the fence as the property line between the adjacent parcels.

Is the fence line the true boundary line?

Yes! When the owners of adjacent real estate are **uncertain** where their boundary is located, they can agree to set a new boundary line. Further, the **agreed-to boundary** which remains in place for more than five years is binding on subsequent owners even though the recorded legal description is different. [**Joaquin** v. **Shiloh Orchards** (1978) 84 CA3d 192]

Uncertain boundaries

Uncertainty over the exact location of a boundary line may arise in a number of circumstances.

For example, where natural markers, such as trees, boulders or a creek, were used to mark a beginning or ending point for a boundary line, the location of the markers may have changed or the markers may have disappeared over time.

Section posts and other surveyor's monuments which indicate boundary lines are also subject to earth movement, climatic changes and human activity. Also, the legal descriptions for parcels of real estate may be conflicting or simply fail to correctly set a boundary line, or the descriptions do not coincide with another line or boundary.

An actual dispute over a boundary's location need not exist between the owners of adjacent parcels. Instead, owners must merely be in doubt over the location of the true boundary and agree to the location of the boundary when they set it.

Usually, it is not the original owners who squabble over title or possession based on the agreed-to boundary line, it is the later owners.

However, when the boundary line in a recorded deed is readily ascertainable by a surveyor, the description in the record controls, unless the landowner defending the location of the line as the common boundary provides cogent proof the boundary line as located settles an actual, not implied, boundary dispute. [Bryant, *supra*]

Agreement to make certain

An agreement to mark a boundary line may be oral, written or result from the conduct of neighboring property owners. Oral or written agreements on the boundary's location are called *express agreements* since they are not implied.

Written expressions are best since they formally document the mutual intentions of the owners. However, they usually exist only in the case of a lot line adjustment map.

Unlike the conveyance of real estate, owners do not have to put their boundary agreement in writing for it to be enforceable. With the setting of an agreed boundary, neither owner is conveying real estate to the other. Instead, the owners are agreeing to what land constitutes their own property.

The element of duration

Owners must acquiesce to the agreed boundary for a period of at least five years, the *statute of limitations* for the recovery of real estate. [Calif. Code of Civil Procedure §318]

The statute of limitations requires the adjacent owners to resolve a dispute within the five-year period. If disputes are not settled within this period, the claims are put to rest. Thus, an owner who fails to object to a boundary line during the statute of limitations period is presumed to have agreed to the boundary set by the adjacent property owner.

However, an agreed boundary can be established even if the **five-year period** has not run. An exception to the five-year rule arises if substantial loss will be caused by the movement of the agreed boundary to the true lot line.

For example, when an adjacent owner builds improvements near the line established in reliance on an agreement that it is the boundary, the new boundary will be allowed without the enforcement of the five-year period. However, the new boundary will only be allowed if the adjacent owner can show moving the boundary will result in substantial loss due to the existence of improvements. [**Roman** v. **Ries** (1968) 259 CA2d 65]

Marking the line

When a writing setting the boundary is not available, subsequent owners must look to the prior owner's activities for an **implication** that an agreement existed as to the location of the boundary line.

For example, the construction of a fence may imply an agreement to set a boundary. However, in order for the fence to control in an agreed-boundary dispute, the owner relying on the fence as a boundary must present evidence to show the fence was erected to resolve a **boundary uncertainty known** to previous owners.

For example, a fence is erected between two parcels of real estate by the owners of the parcels. Both parcels are later sold.

The new owner of one of the parcels commissions a survey based on the legal description of the property in recorded documents. The survey reveals the 20-year old fence dividing the owner's property and the neighboring property is actually located on his property.

The owner builds a new fence on the actual boundary line located by the survey.

The neighbor then seeks to remove the new fence and obtain possession to the real estate up to the old fence line. The neighbor claims the agreed-boundary doctrine sets the boundary at the original fence line since the fence existed for 20 years without dispute.

The owner claims the agreed-boundary doctrine does not apply since the previous landowners did not agree to erect the fence based on any uncertainty as to the location of the true boundary. Can an agreement be implied to set the boundary line at the old fence?

No! The mere acquiescence to the placement of a fence, absent evidence of uncertainty and an agreement to resolve the uncertainty, is not enough to establish a boundary under the agreed-boundary doctrine. The agreed-boundary doctrine does not apply since the previous owners did not erect the fence to resolve uncertainty as to the location of the boundary. [**Mehdizadeh** v. **Mincer** (1996) 46 CA4th 1296]

Fences are built for a variety of reasons, one of which is to establish a boundary. Other reasons for erecting fences include controlling animals, aesthetics or to prevent children from wandering off a property.

Further, the location and condition of a fence may be influenced by the topography of the property, the terrain on which it is placed, requirements of an animal enclosure, or the loss of lateral and subjacent support. [Bryant, *supra*]

While a fence or wall is evidence of a line for something, a fence does not necessarily set the property boundary.

Limitations of the doctrine

The agreed-boundary doctrine has limitations. The doctrine cannot be used to convey property. Further, the agreed-boundary doctrine can only set a boundary, the exact location of which is unknown to the adjacent owners without a survey or litigation.

Any attempt to convey a portion of a lot to the owner of an adjacent property by use of the agreed-boundary doctrine violates the Statute of Frauds which requires a writing stating the intent to convey land.

Thus, the agreed-boundary doctrine cannot be used to make *lot line adjustments*. In a **lot line adjustment**, the adjacent owners are moving an already existing line, the location of which is known to them.

Lot line adjustments require planning commission approval. [Calif. Government Code §66469 et seq.]

Chapter 39 Common boundary structures

This chapter is a digest of the rights and obligations of owners in common boundary disputes.

For a further discussion of this topic, see Chapter 14 of Legal Aspects of Real Estate.

Chapter 39 Outline

Shared rights and responsibilities
Party walls are owned by both
Boundary fences and cost contributions
Sharing boundary trees

Chapter 39 Terms

Boundary fence	*Line trees*
Common boundary improvement	*Party walls*
Common boundary trees	

Shared rights and responsibilities

Most properties have three property lines which set the **common boundary** with adjacent properties owned by other people. A fourth property line usually sets the frontage on a public right of way, such as a street.

The location of the common property lines might be represented by an improvement which acts as a demarcation of the property line, called a *common boundary improvement*.

A common boundary improvement may be a:

- party wall;
- boundary fence;
- tree line;
- driveway; or
- ditch.

Prospective buyers interested in a property should be concerned about the ownership of any common boundary improvements and who is responsible for their maintenance.

The rights of the adjacent property owners when setting up, maintaining or removing common boundary improvements depend on the type of improvement which exists.

Party walls are owned by both

Common boundary improvements, other than trees, located on a property line between adjacent properties are called *party walls*.

A **party wall** may be in the form of a wall, fence or building which is co-owned by the adjacent property owners.

The use and ownership of a party wall should be set forth in a written agreement between adjacent property owners. The agreement defines each owner's responsibility for **sharing the cost** of maintaining the party wall. However, these written agreements rarely exist.

Similarly, an adjoining property owner cannot **remove or destroy** a party wall without the consent of the other owner since each has an interest in the party wall.

An owner can alter a party wall, such as installing cosmetic ornamentation on his side of the wall, as long as he does not injure the wall or interfere with the adjoining property owner's use of the party wall. [**McCarthy** v. **Mutual Relief Ass'n of Petaluma** (1889) 81 C 584; Tate, *supra*]

Boundary fences and cost contributions

For security and privacy purposes, many properties are fenced in by a *boundary fence*. A **boundary fence** may be a party wall co-owned by the adjacent property owners.

Adjacent property owners have a mutual obligation to maintain the fences between them, except for an owner who allows his land to lie otherwise unfenced. [Calif. Civil Code §841(1)]

If an owner who leaves his land unfenced later decides to enclose it by using the existing fence as part of the enclosure, he must compensate the neighbor who built the fence for the pro rata value of the neighbor's fence used by the owner. [CC §841(2)]

Line trees, a trunk with common owners

Trees are solely owned, government owned or commonly owned. A tree's **ownership** is determined by the location of its trunk.

Solely owned trees belong to the owner of the property on which the trunk is growing. [CC §833]

However, shrubbery or trees whose trunks stand partly on the land of two adjacent property owners belong to the adjacent owners as **tenants in common**. These trees are called *line trees* or *common boundary trees*. [CC §834]

Adjacent owners who own line trees as tenants in common are jointly responsible for maintaining the trees. [CC §841]

Sharing boundary trees

Co-owners of boundary trees, as adjoining property owners, both enjoy the use of the trees.

For example, **use** of a boundary tree by adjacent property owners includes trimming and maintaining the trees. The co-owner who trims the tree must carry away and dispose of the tree trimmings. The co-owner must also take care not to damage the tree or interfere with the other co-owner's use of the tree.

The use allowed a co-owner of boundary trees is the same as the use allowed the owner of solely-owned trees, as long as the use does not interfere with the other co-owner's use and enjoyment of the trees.

Remedies

If a boundary tree injures the *health and safety* of a property owner or prevents him from enjoying his property, the tree may constitute a **nuisance** and can be removed. [CC §3479]

A co-owner of a boundary tree might refuse to consent to the removal of a boundary tree. If the tree constitutes a nuisance, an abatement of the nuisance is allowed.

For example, boundary trees may be a nuisance if their branches or the trees themselves continually fall, threatening the safety of people using the adjacent property or damaging improvements on the adjacent property. [**Parsons** v. **Luhr** (1928) 205 C 193]

Chapter 40 — Encroachments: crossing the line

This chapter discusses the rights of neighboring owners of real estate when improvements on one owner's property encroach on the property of the other.

For a further discussion of this topic, see Chapter 15 of Legal Aspects of Real Estate.

Chapter 40 Outline

Boundaries violated and hardships balanced
Encroachment, trespass and nuisance
Rights affected
Drawing the line
Balancing the hardships
Good faith and innocence
The encroachment easement
Limitations and delay

Chapter 40 Terms

Balancing hardships	*Laches*
Continuing nuisance	*Nuisance*
Encroachment	*Permanent nuisance*
Equitable easement	*Statute of limitations*
Good faith	*Trespass*
Injunction	

Boundaries violated and hardships balanced

Shortly after his purchase of an unimproved parcel of real estate, the owner discovers the garage on his neighbor's property extends two feet over the boundary line onto his property, called an *encroachment*.

The owner demands the neighbor remove the **encroachment**. When the neighbor refuses, the owner seeks to compel the neighbor's removal of the portion of the garage which encroaches on his property.

The neighbor claims the owner is not entitled to a removal of the improvement since:

- the encroachment was unknown and unintentional;
- the square footage of the owner's property affected by the encroachment is minor; and

- the cost to remove the garage would far exceed the monetary loss to the owner if the encroachment were allowed to continue.

Can the owner obtain a court order forcing the removal of the encroaching garage, called an *injunction*?

No! The encroachment is unintentional and minor in its effect on the burdened owner. Thus, the burden to the owner does not justify ordering the neighbor to undertake an expensive reconstruction activity.

Instead, the owner is awarded money damages representing the rental value for the lost use of his property, and the neighbor is granted an easement over the owner's property for the life of the garage. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

For the neighbor to be allowed to maintain the encroachment, he has to act in *good faith* when building the improvements, i.e., without knowledge the improvements encroached on the owner's property. If the neighbor had not constructed the improvements in **good faith**, the owner would be entitled to an injunction forcing the removal of the encroaching structure no matter how minor the encroachment.

Also, for the owner to recover money damages for the encroachment, he has to act within the three-year period of the **statute of limitations**. If the owner delays too long in making his claim, the encroaching neighbor would earn the right to maintain the encroachment without paying any damages at all.

Even if a new owner of a property burdened by an encroachment seeks an injunction or money damages from the neighbor immediately after acquiring the property, his action can be barred by the statute of limitations.

The limitations period does not run from the discovery of the encroachment or the acquisition of the property, but from the creation date of the encroachment.

Of course, the buyer could recover losses from the seller caused by the seller's failure to disclose the existence of a known encroachment. The loss would be based on the diminished value of the property and the excess purchase price paid.

Encroachment, trespass and nuisance

An **encroachment** is an improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without his consent.

Encroachment is closely related to trespass, nuisance and boundary disputes. All involve an interference with another person's property rights.

Any encroachment qualifies as a *nuisance*, be it a **permanent** or **continuing nuisance**, since nuisance is broadly defined as any obstruction of another's use and enjoyment of his real estate.

An encroachment is also a *trespass* when it actually rests on the ground of the neighbor's property.

However, the names used for an interference are unimportant. One way or another, an owner is entitled to recover for an **unauthorized interference** with his property rights.

Rights affected

It is not only the fee owner of real estate who can seek to stop an encroachment. Any person holding rights in real estate may protect those rights against outside interference. Thus, the rights affected by an encroachment can include:

- *leasehold* interests [**Brown Derby Hollywood Corporation** v. **Hatton** (1964) 61 C2d 855];
- *deed restrictions,* such as limitations on the height of improvements [**Seligman** v. **Tucker** (1970) 6 CA3d 691];
- *setback* requirements [**Morgan** v. **Veach** (1943) 59 CA2d 682];
- *easements* [**City of Dunsmuir** v. **Silva** (1957) 154 CA2d 825]; and
- *prescriptive easements*. [**Warsaw** v. **Chicago Metallic Ceilings, Inc.** (1984) 35 C3d 564]

For instance, an owner uses a strip of his neighbor's property for access to a commercial building located on the owner's property. After the owner uses the strip for more than five years, the neighbor constructs a warehouse on the strip of land, restricting the owner's access to his building.

However, the owner's use of the strip of his neighbor's land matured into an **easement by prescription**. Thus, the owner is able to obtain an injunction against the warehouse improvements as they encroach on his easement rights. [Warsaw, *supra*]

Drawing the line

The existence of an encroachment is easily determined. All that is needed is a survey to locate the property line. If an improvement on one parcel extends over the line onto an adjacent parcel, it is an encroachment.

Occasionally, neighboring owners disputing the existence of an encroachment rely on contradictory surveys to establish the property line. If the owners cannot agree on the location of the property line, the boundary dispute must be resolved before any remedy for the encroachment — if one exists — can be granted.

The resolution of the boundary dispute frequently amounts to no more than a court determining which of the surveys is more accurate. [**Iacovitti** v. **Fardin** (1954) 127 CA2d 348]

However, where the boundary is marked by a physical structure, such as a fence or a row of trees, a survey is not always to be relied on.

For instance, a common boundary line marked by a fence or other structure is not located on the recorded description of the lot line. Both neighbors treat the fence as the boundary for a number of years. The agreed-to location of the property line is the boundary, regardless of deeds and surveys to the contrary.

Once an **encroachment** has been determined, the remedies available to the owner include:

- an **injunction** ordering the removal of the encroaching structure; and
- **money damages** for the diminished value of the property.

Balancing the hardships

An owner is entitled to terminate or prevent an unauthorized intrusion onto his real estate. However, when a building or other substantial improvement encroaches on an owner's property, the neighbor's cost of removing the encroachment may far exceed the damage inflicted on the owner burdened by the encroachment.

Thus, the encroachment is allowed to continue and the owner is awarded money damages for the lost use of his property, called *balancing hardships* or *balancing equities*.

The conditions for balancing equities — i.e., merely granting money damages and allowing an encroachment to continue — are:

- the owner of the property affected by the encroachment must not suffer an *irreparable injury* due to the continued existence of the encroachment;
- the neighbor who owns the encroaching structure must have acted innocently and in **good faith**; and
- the **cost** to the neighbor of removing the encroachment must greatly exceed the damage done to the owner. [Christensen, *supra*]

For instance, a neighbor's residence is located close to the property line. The eaves of the house and a bay window hang out over the line. The encroaching portions of the structure can be removed without great expense or loss of value.

The owner demands the removal of the encroaching structures.

The neighbor claims removal is not appropriate since the encroachment is minimal.

However, since the encroachment is minimal and the cost of removing it is small, the encroaching portion of the residence must be removed — tipping the balance in favor of eliminating the encroachment. [**Harland** v. **Noto** (1951) 105 CA2d 740]

An encroachment need not be removed if removal would adversely affect a large segment of the public.

For example, a reservoir constructed by a water company encroaches on an owner's property. The owner seeks to remove the encroachment. However, the encroaching reservoir may remain partly because the reservoir supplies water to over 500 homes. [**Ukhtomski** v. **Tioga Mutual Water Co**. (1936) 12 CA2d 726]

Good faith and innocence

The good faith of a neighbor who constructs improvements which encroach on the land of another must exist before any balancing of the hardship of removal or remaining can take place.

The good faith requirement prevents an **intentional exploitation** of the balancing hardships rule.

For example, an unimproved parcel of real estate is subject to setback requirements. The owner begins building a residence on the property.

Soon after construction commences, the owner's neighbor notices the residence is being constructed within the setback — too close to the property line. The owner is informed he is violating the setback requirements. The neighbor also threatens legal action unless the owner complies with the setback requirements.

However, the owner does not cease work on the residence. He completes the construction knowing the improvements violate the setback requirements. The neighbor seeks to enforce the setback requirements by forcing the removal of the structure from within the setback.

The cost to the owner of removing the residence far exceeds the damage to the neighbor.

However, the owner built the residence with full knowledge of both the setback violation and the neighbor's objection. Thus, the owner did not complete the construction in good faith and the portion of the structure within the setback must be removed. Had the owner innocently violated the setback requirements, the removal request would probably be denied. [Morgan, *supra*]

The encroachment easement

When the continuance of an encroachment on the owner's property is allowed, the encroaching neighbor is granted an *equitable easement* to maintain the improvement on the owner's property. Further, the neighbor must compensate the owner for the rental value of the lost use of his property. The easement lasts for the lifetime of the encroachment.

To resolve one case, the encroaching neighbor sought fee title to the portion of the property covered by his encroachment. However, to grant title would be excessive. Instead, an easement is granted since an easement is sufficient to protect the neighbor's right to maintain the encroaching improvements and avoid **lot line adjustment laws**. [Christensen, *supra*]

Limitations and delay

Normally, an owner seeking to terminate an encroachment or recover money damages is subject to a **three-year statute of limitations** running from the commencement of the encroachment. [**Bertram** v. **Orlando** (1951) 102 CA2d 506]

The limitations period for an encroachment is the same as for a *permanent nuisance* since the damage to the owner is complete and certain as soon as the encroachment is created.

The **creation date** of the encroachment is the critical date. Whether or not an owner has knowledge an encroachment exists does not affect the statute of limitations. The limitations period runs from the creation of the encroachment, not its discovery. [**Castelletto** v. **Bendon** (1961) 193 CA2d 64]

However, in the rare case where damage resulting from an encroachment is progressive over time, the three-year statute of limitations does not apply from the date of creation.

For instance, an owner's building is damaged when a neighbor's building leans on it, due to a poorly compacted fill. The degree of the tilt, and the resulting damage, increases over time.

More than three years after the damage commences, the owner seeks to recover his monetary losses from the neighbor. The neighbor claims the owner is barred from recovering damages by the running of the three-year limitations period.

However, the intrusion on the owner's building is continuous and progressive — a further intrusion. As with a *continuing nuisance*, a new claim accrues each time the loss increases. Thus, while the three-year statute of limitations does apply, it does not begin to run on the commencement of the encroachment, but runs from the date of the last increase in damage from the progressively increasing encroachment. [**Kafka** v. **Bozio** (1923) 191 C 746]

In addition to barring relief due to the statute of limitations, an action seeking money damages or an injunction against an encroachment can be barred by the equitable doctrine of *laches*, also called *prejudicial delay* or *detrimental reliance*.

A property owner loses his right to enforce a removal of an encroachment or recover money against the encroaching neighbor if the owner delays in making the claim causing the neighbor to rely on the owner's acquiescence to his detriment.

For example, if an owner discovers his neighbor is constructing a potential encroachment, but refrains from saying anything or taking any action until the construction is completed, he can be barred from enforcing its removal. The encroaching neighbor has relied on the owner's acquiescence in undertaking and completing the construction. [**Rankin** v. **De Bare** (1928) 205 C 639]

Finally, an owner who allows a known encroachment on his property to continue for over five years risks losing property rights through a prescriptive easement or adverse possession since the adverse use of the owner's property by the encroaching neighbor is known to the owner and continuous.

Thus, an owner must act promptly to enforce his right to remove the encroachment or receive compensation for lost value when a neighbor's improvements encroach on his property.

Chapter 41 — Trespass: a violation of possession

This chapter examines the activities which constitute trespasses on real estate and lists the available remedies.

For a further discussion of this topic, see Chapter 18 of Legal Aspects of Real Estate.

Chapter 41 Outline

Ejectment, liabilities and title risks
Trespasser liability for harm done
Indirect trespass
Injunction to abate a trespass
Criminal trespass on refusal to leave

Chapter 41 Terms

Civil liability	*Trespass*
Indirect entry	*Waste*
Nominal money damages	

Ejectment, liabilities and title risks

A *trespass* is any wrongful and unauthorized entry onto real estate in the possession of another.

Thus, a **trespass** is an interference with another's **possession** of real estate, which is distinct from any interference with **title** or an **ownership interest**. [**Brenner** v. **Haley** (1960) 185 CA2d 183]

The person entitled to stop a trespass is not necessarily the fee simple owner or the owner's agent. Anyone in possession of the property, such as the fee owner, a life estate owner, a tenant or even a person in wrongful possession, has the right to stop a trespass. [**Allen** v. **McMillion** (1978) 82 CA3d 211]

Trespasser liability for harm done

When an entry is not privileged, it is considered a trespass. A trespasser incurs **civil liability** for the monetary amount of any losses or injury he causes to the occupant's person, real estate or personal property.

An occupant of property, who might be someone other than the fee owner, can recover his money losses for injuries resulting from a trespass. Conversely, damage to the fee owner's property caused by the person who is in rightful possession, such as a tenant, is not a trespass, it constitutes *waste* since he has impaired the property's value. [**Smith** v. **Cap Concrete** (1982) 133 CA3d 769]

An owner may bring an action for trespass against a trespasser even when the trespasser caused no actual injury by his presence in the owner's property. If no injury has occurred, the owner may only recover *nominal money damages* from the trespasser. **Nominal money damages** are awarded when a wrong has been committed under the law but has not resulted in a money loss. [**Staples** v. **Hoefke** (1987) 189 CA3d 1397]

To recover *actual money damages* for a trespass, an owner must sustain an actual loss. **Actual money damages** recoverable for a trespass are based on:

- injury to the real estate;
- lost use of the property;
- personal injury; and
- injury to the occupant's personal property.

Indirect trespass

A trespass does not require the trespasser's direct physical presence on the property. A trespass can result from an **indirect entry** into another's property, sometimes called *trespass on the case*.

For example, one can be liable on a trespass for damages caused by activities such as:

- depositing dirt or debris on another's property [**Armitage** v. **Decker** (1990) 218 CA3d 887];
- leaving toxic waste on another's property [**Mangini** v. **Aerojet-General Corporation** (1991) 230 CA3d 1125];
- leaving personal property on real estate belonging to another [**Herond** v. **Bonsall** (1943) 60 CA2d 152];
- diverting a river or surface waters across another's property [**Salstrom** v. **Orleans Bar Gold Mining Co.** (1908) 153 C 551];
- starting a fire and negligently allowing the fire to move onto a neighbor's property [**Elton** v. **Anheuser-Busch Beverage Group, Inc.** (1996) 50 CA4th 1301]; or
- allowing one's animals to wander across another's property. [**Montezuma Improvement Co.** v. **Simmerly** (1919) 181 C 722]

Injunction to abate a trespass

Besides recovering money losses, an owner can obtain a court ordered **injunction** to stop a person who is a continuing trespasser.

A single isolated trespass is not a basis for an injunction. However, if seeking money damages would not prevent a trespass from being repeated in the future, the rightful occupant can obtain an injunction against the trespasser. [**Standard Lumber Co.** v. **Madarys Planing Mill** (1921) 54 CA 107]

Criminal trespass on refusal to leave

In addition to the liability for property damages, a trespasser may also incur **criminal** liability. Trespassing becomes a **misdemeanor** when the trespasser:

- *refuses to leave the property* on foot or in a vehicle when requested by the owner, the owner's agent, a person in lawful possession of the property or a law enforcement officer acting on request from the person entitled to possession [Calif. Penal Code §602(k), (n)];
- enters and *occupies the property* without the rightful owner's consent [Pen C §602(m)];
- *refuses to leave a transient occupancy* establishment (hotel/motel/vacation property) on the request of the owner or manager [Pen C §602(s)];
- *enters a private dwelling* [Pen C §602.5]; or
- *enters industrial property* (such as an oil field, a gas or electric plant or a railroad yard) where posted signs forbid trespassing. [Pen C §554]

A crime is not committed by merely entering another's property, except when the property is a private residence or posted industrial property.

Chapter 42 — Nuisance: offensive, unhealthful or obstructive

This chapter defines a nuisance, distinguishes it from trespass and describes a property owner's remedies to stop it.

For a further discussion of this topic, see Chapter 19 of Legal Aspects of Real Estate.

Chapter 42 Outline

Interference with use and enjoyment
Nuisance per se by statute
Balancing rights: inconvenient or improper
Public vs. private nuisance
Permanent or continuing nuisance
Permanent nuisance remedies
Continuing nuisance remedies
Statute of limitations on recovery

Chapter 42 Terms

Abatement	*Permanent nuisance*
Balancing of the rights	*Public nuisance*
Money losses	*Spite fence*
Nuisance	*Use and enjoyment*

Interference with use and enjoyment

A *nuisance* is anything which:

- is **offensive** to the senses;
- is **injurious** to health; or
- **obstructs** the use of property. [Calif. Civil Code §3479]

Thus, a nuisance is any activity which interferes with the **use and enjoyment** of property, including conditions which are unhealthy or offensive to the senses.

The common law definition of a nuisance was limited to conduct on one property which interferes with the use and enjoyment of a different property. However, a nuisance is now broadly interpreted to encompass a wide variety of activities.

Consider a residential landlord who maintains his rental units in an **unsafe condition**. In addition to being a breach of the implied warranty of habitability, the tenants may also pursue an

action against the landlord for maintaining a nuisance A **residential landlord** maintains a *nuisance* by failing to care for and maintain his units, and he is liable to the tenants for their losses, including relocation expenses. [**Stoiber** v. **Honeychuck** (1980) 101 CA3d 903]

A nuisance does not need to be offensive to the senses or injurious to health to constitute a nuisance. A **nuisance** only needs to interfere with the *use and enjoyment* of a property right in some **physical manner**.

Neighboring property owners inevitably create some degree of **annoyance or inconvenience** for each other, but not every annoyance rises to the level of a nuisance.

An activity becomes a nuisance based on either:

- a statutory provision identifying conduct that is a *nuisance per se*; or
- a balancing of the conflicting rights and interests of the neighboring property owners.

Nuisance per se by statute

A *nuisance per se* is any activity specifically declared by statute to be a nuisance. If an activity is a statutory nuisance, it can be enjoined without proof of its harmful or offensive effect.

The list of **nuisances per se** is wide and diverse, including:

- fences of excessive height unnecessarily exceeding ten feet, called *spite fences* [CC §841.4];
- the illegal sale of controlled substances [CC §3479];
- fire hazards [Calif. Public Resources Code §4171]; and
- swimming pools which do not comply with statutory health and safety standards. [Calif. Health and Safety Code §116060]

Conversely, some activities are declared by statute not to be nuisances.

Activities done or maintained under the express authority of a statute, called *statutory authority*, cannot be nuisances. For example, the activities of a commercial agricultural processing plant are maintained under **statutory authority** and cannot constitute a nuisance. [CC §§3482, 3482.6]

Balancing rights:
inconvenient or improper

When an activity is not a nuisance per se, to determine whether a **nuisance** exists, a *balancing of the rights* of the neighboring property owners is applied.

Every owner is entitled to use his property for any lawful purpose. However, an owner is limited in his conduct since his permitted use may not unreasonably interfere with the right of others to use and enjoy their property. [CC §3514]

Nuisance vs. trespass

Nuisance and trespass are closely related. The two categories overlap since both involve injury to, or interference with, the property rights of another. The distinction is based on whether a physical entry onto another's property occurs.

Trespass requires a physical entry on another's property which can be direct or indirect — i.e., the trespasser can either personally enter the property or deposit materials indirectly, such as dirt and debris from construction activity.

In contrast, a nuisance is an outside interference with an owner's or tenant's use and enjoyment of his property resulting from a condition or activity which physically remains outside the property.

Thus, trespass is based on an interference with the possession since it affects the real estate. A nuisance is an interference with the enjoyment of property since it affects the senses of the applicants.

For instance, noise is a nuisance to occupants of another property if the noise is loud, annoying and continuous. Noise is not a trespass since no physical invasion of property occurs, except for sound waves which affect the senses, not the property. The noise creates no interference with the possessory rights in another's property and thus is not a trespass. [**Wilson** v. **Interlake Steel Company** (1982) 32 C3d 229]

However, the distinction between nuisance and trespass does not mean the categories are mutually exclusive. Nuisance is broadly defined by statute as anything which is injurious to health or obstructs the use of property, regardless of whether the condition exists on or off the affected property. Thus, an invasion of property which qualifies as a trespass is also a nuisance if the trespass rises to an unhealthful or offensive condition.

For example, consider a tenant who leaves behind hazardous materials which contaminate the leased property after the lease expires. The contamination is both:

- a trespass, since it interferes with the landlord's possession of his property; and
- a nuisance, since it is harmful to the public's health. [**Mangini** v. **Aerojet-General Corporation (**1991) 230 CA3d 1125]

An owner's use of his property often creates some degree of inconvenience for the occupants of neighboring properties. However, to constitute a nuisance, the inconvenience created by an owner's use of his property must be serious enough to be an **improper interference** with another's use and enjoyment of his property.

Whether an activity is a nuisance is determined on a case-by-case basis. An activity which is a nuisance in one set of circumstances may not be a nuisance in another, depending on such factors as:

- the frequency and time of day of the activity;
- the number of inhabitants in the area; and
- the injury or inconvenience caused to occupants of surrounding property by the activity. [**McIntosh** v. **Brimmer** (1924) 68 CA 770]

Public vs. private nuisance

A **nuisance** may be a public nuisance, a private nuisance or both.

A *public nuisance* is a nuisance which affects an entire neighborhood or segment of the public. [CC §3480; Calif. Penal Code §370]

Stopping a **public nuisance** is the responsibility of state or local government authorities. Officials may seek to abate or enjoin the nuisance, recover money damages or bring criminal misdemeanor charges against the offender responsible for the nuisance. [Pen C §372]

A private property owner may not stop a public nuisance unless the public nuisance especially obstructs the owner's use of his property, making the interference a private nuisance as well. [CC §3493]

For a private owner to abate a public nuisance by an injunction, he must sustain injuries to himself or to his property which are **different in kind** from the interference or injuries sustained by the public at large.

Permanent or continuing nuisance

The type of money losses an owner can recover for property damage caused by a nuisance depends on whether the nuisance is *permanent* or continuing. A **permanent nuisance** exists when the nuisance cannot be abated at a reasonable cost and by reasonable means. [**Mangini** v. **Aerojet-General Corporation** (1996) 12 C4th 1087]

Conversely, a **continuing nuisance** exists if the nuisance can be reduced or terminated at any time and at a reasonable expense.

The money losses inflicted by a permanent nuisance are determined at the time the permanent nuisance is created. Losses inflicted by a continuing nuisance are limited to the actual injuries suffered prior to termination of the nuisance. [**Spar** v. **Pacific Bell** (1991) 235 CA3d 1480]

Permanent nuisance remedies

A **permanent nuisance** cannot be abated at a reasonable expense or by reasonable means. Thus, an owner's only remedy is a recovery of *money losses* calculated as the diminished value of his property caused by the nuisance.

For instance, a building on a neighbor's property encroaches on the adjacent owner's property. The **encroachment** is a permanent nuisance since it perpetually obstructs the use and enjoyment of the owner's property and cannot be removed at a reasonable cost to the neighbor.

In balancing the rights of the adjacent owner and the encroaching neighbor, the cost to the neighbor to abate the nuisance by removing the encroaching improvements far exceeds the loss of the owner's use. Thus, the owner is entitled to monetary compensation for the lost use of the portion of his property hindered by the encroachment, but he cannot abate the encroachment itself. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

Continuing nuisance remedies

In the case of a **permanent nuisance**, an owner can recover *money losses* equal to the permanent decline in his property's value caused by the nuisance.

However, recovery for a **continuing nuisance** cannot include lost property value since the nuisance can be entirely eliminated.

The condition causing the diminished value will no longer exist once the nuisance is removed. Thus, no permanent loss in value occurs to be recovered. [**Alexander** v. **McKnight** (1992) 7 CA4th 973, *supra*]

The primary remedy for a **continuing nuisance** is an *abatement* to remove the nuisance or an *injunction* ordering the nuisance to be stopped. However, an owner can also recover the costs he incurs to remedy the damage done by the nuisance to his real estate.

In addition to an injunction, other money losses which can be recovered by the owner are limited to:

- the lost use of the property until the nuisance is abated, such as rental value;
- the cost of cleanup or repairs necessary to eliminate the nuisance; and
- any expenses incurred due to personal injury or emotional distress caused by the nuisance.

Statute of limitations on recovery

The status of a nuisance as *permanent* or *continuing* affects recovery under the three-year statute of limitations barring further claims based on the nuisance. [CCP §338]

Chapter 43 — Easements: running or personal

This chapter presents the various types of easements and the rights and obligations unique to each.

For a further discussion of this topic, see Chapter 20 of Legal Aspects of Real Estate.

Chapter 43 Outline

Rights in another's property
Benefits and burdens of ownership
Appurtenant or in gross: does it run?
Runs with title to the benefitting property
Easements for light, air or view
Solar easements and shady neighbors
Conservation easements

Chapter 43 Terms

Appurtenant easement	*Ingress and egress*
Conservation easement	*Servient tenement*
Dominant tenement	*Solar easement*
Easement in gross	

Rights in another's property

An *easement* is the right of one property owner **to use** the property of another. A typical **easement** is used for *ingress and egress*, which is a right of way allowing one property owner to traverse a portion of another's land (the easement) to access his property.

When an owner whose property is burdened by an easement interferes with the use of the easement by a neighbor whose property benefits from the easement, the neighbor is entitled to have the use of the easement reinstated, either by removal, relocation or modification of the interference.

Further, the neighbor who holds the easement is entitled to compensation for his money losses caused by the owner's obstruction of the neighbor's use of the easement. [**Moylan** v. **Dykes** (1986) 181 CA3d 561]

Benefits and burdens of ownership

An easement creates a relationship between two parcels of real estate since it:

- **benefits** one property, referred to as the *dominant tenement*, whose owner is entitled to use the easement; and

- **burdens** another property, referred to as the *servient tenement*, the owner's use of which is subject to the easement.

Appurtenant or in gross: does it run?

An easement burdening an owner's property as an *encumbrance on his title* is classified as either:

- an **appurtenant easement**, since the allowed use belongs to and benefits an adjacent property and *runs with the land* as an interest held in the burdened real estate; or

- an **easement in gross,** which belongs to an individual, not land, as his *personal right* in the burdened real estate.

Runs with title to the benefitting property

An *appurtenant easement* is incidental to the title of the property which benefits from its use. An easement is not reflected as a recorded interest on the title to the parcel of land it benefits, nor is it a personal right held by a particular individual who may now or have previously owned the land benefiting from the easement.

Accordingly, an **appurtenant easement** is recorded as an encumbrance on title to the burdened property. The easement remains on the property's title after either the benefitting or burdened property are conveyed to new owners. To be enforceable, the easement does not need to be referenced in the grant deed conveying either property to new owners since it runs with the land. [Moylan, *supra*]

Conversely, an *easement in gross* benefits a person, not the real estate owned by that person. An easement in gross is personally held only by the individual who may use the easement. No parcel of real estate can benefit from an easement in gross since only the individual holding the easement can benefit.

While an easement in gross is a **personal right** which is not transferred with the sale of any real estate owned by the holder of the easement, the right can be *transferred* by the easement holder to another person by a writing — unless the transfer of the easement in gross is prohibited by a provision in the document creating the easement. [**LeDeit** v. **Ehlert** (1962) 205 CA2d 154]

Easements for light, air or view

A property owner has no automatic right, and can not acquire a prescriptive right, to air, light or an **unaltered view** over neighboring properties.

However, a property owner can hold an easement created by a grant which restricts a neighbor's ability to erect or maintain any improvement interfering with the owner's right to air, light or view. The easement might be the result of conditions, covenants and restrictions (CC&Rs) which blanket several properties with use restrictions on height, etc.

Easements for light, air and view can only be established by *written agreement* between neighboring owners, not by implication or prescription. [Petersen, *supra*]

Solar easements and shady neighbors

A relatively recent type of easement is the *solar easement*. **Solar easements** were established with the intent of encouraging, as public policy, the productive use of solar energy systems.

A solar easement granted in a written instrument must state:

- the measured angles by which sunlight must pass;
- the hours of the day during which the easement is effective;
- the limitations on any object which would impair the passage of sunlight through the easement; and
- the terms for terminating or revising the easement. [Calif. Civil Code §801.5]

Solar easements are similar to easements of light, air or view since they restrict an owner's ability to maintain any improvements interfering with a neighbor's solar energy system.

Conservation easements

A *conservation easement* is a voluntary conveyance — by an owner of real estate to a conservation organization or government agency — of the right to keep the land in its natural, scenic, historical, agricultural, forested or open-space condition. A **conservation easement** can be created in the form of an easement, covenant, condition or restriction (CC&Rs), by use of a deed, will or other instrument to convey the easement. [CC §815.1]

Conservation easements are *perpetual* in duration and thus are binding on all successive owners of the property burdened by the conservation easement. [CC §§815.1, 815.2(b)]

Conservation easements can only be granted to organizations established to acquire and hold a conservation easement, namely:

- a tax-exempt, nonprofit organization qualified to do business in the State of California whose primary purpose is to preserve, protect or enhance land in its natural, scenic, historical, agricultural, forested or open-space condition or use;
- a state or a governmental entity authorized to acquire and hold title to real estate, as long as the conservation easement is voluntarily conveyed; and
- a federally recognized California Native American tribe or a nonfederally recognized California Native American tribe on the contact list of the Native American Heritage Commission. [CC §815.3]

Chapter 44 — Creating an easement

This chapter presents the methods used to create an easement.

For a further discussion of this topic, see Chapter 21 of Legal Aspects of Real Estate.

Chapter 44 Outline

By grant, reservation or implication
Easement or fee title conveyed by deed
Conduct creates an implied easement
Reasonable necessity to use another's
Implied is appurtenant
Easements by necessity

Chapter 44 Terms

Appurtenance	*Grant*
Bona fide purchaser	*Implied easement*
Conveyance	*Reservation*
Easement by necessity	*Unrecorded easement*
Easement by reservation	

By grant, reservation or implication

The basic method for creating an easement is by a writing. Any document which may be used to convey a legal interest in real estate may be used to create an easement.

An easement can be created between the benefitting and burdened properties in an easement agreement, will, grant deed, easement deed, quitclaim deed, lease, order of the court or *covenants, conditions and restrictions (CC&Rs)*.

While the document creating an easement does not have to be recorded, an *unrecorded easement* is no longer enforceable when the owner of the burdened property sells it to a buyer who has no knowledge of the easement, called a *bona fide purchaser (BFP)*.

An **easement** is created in a *conveyance* either by:

- *grant*; or
- *reservation*.

For example, the owner of adjacent parcels of real estate can sell one parcel to a buyer and further **grant** the buyer an easement on the parcel retained by the owner.

Alternatively, an owner of adjacent parcels may sell a parcel, and in the grant deed conveying the parcel, **reserve** an easement on the parcel conveyed for the benefit of the parcel retained.

Easement or fee title conveyed by deed

The terms *reservation* and *exception* in conveyances of real estate are used to distinguish whether the legally described reservation or exception is, respectively:

- created for the benefit of another property, such as an *easement by reservation*; or
- retained as the property of the seller, an *exception for land* which is not transferred with the title conveyed.

The terms **reservation** and **exception** are often mistakenly used interchangeably. However, their meanings and operative effects are very different.

Conduct creates an implied easement

An easement can be created by conduct without any prior agreement between the owner and the user, called an *implied easement*.

Implied easements exist when the circumstances surrounding an owner's *division of his property* and sale of a portion of the property imply the owner (grantor) and the buyer (grantee) intended either:

- the grant of an easement on the portion retained by the owner; or
- the reservation of an easement by the owner on the portion sold. [Calif. Civil Code §1104; **Palvutzian** v. **Terkanian** (1920) 47 CA 47]

Reasonable necessity to use another's

For an implied easement to exist, the easement must be *reasonably necessary* for the beneficial use of the parcel whose owner is seeking to establish the easement.

Consider a owner who sells and conveys a parcel containing a driveway. The owner uses the driveway to access an adjoining parcel he owns which is improved by his residence.

The owner does not reserve an easement for use of the driveway in the conveyance to the buyer. The owner's residence fronts on a public road.

However, the driveway through the buyer's parcel is the only improved access to the owner's residence.

On closing, the buyer refuses to allow the owner to use the driveway over the parcel sold to him.

The owner claims he is entitled to an implied easement over the parcel sold to the buyer since, prior to the sale, the driveway provided access to the adjoining property he retains.

The buyer claims the owner is not entitled to an implied easement since he can build a new driveway to the public road at a reasonable cost.

Is the owner entitled to an implied easement to use the buyer's driveway?

No! An implied easement (by reservation) is not reasonably necessary to the owner's beneficial use of the adjacent property he retained since the owner can build a new driveway to the public road at a reasonable cost. [**Leonard** v. **Haydon** (1980) 110 CA3d 263]

Thus, an implied easement is created for the benefit of property only if a **reasonably convenient alternative** is not available to the property and a reasonable necessity for the easement exists.

Implied is appurtenant

Regardless of how an *implied easement* is created, it is always a **burden** on one parcel of land for the **benefit** of another parcel. Thus, an implied easement is always an *appurtenance* allowing the owner of the property benefitting from the easement to use the property of another which is burdened by the easement.

Most disputes over implied easements occur after the property benefitting from the easement has been deeded out to one or more new owners.

To be entitled to an implied easement, the new owner must establish the implied easement is a right of use in another property which existed when one of the parcels was deeded out to the new owner by the common owner of both parcels.

Easements by necessity

An *easement by necessity* is a variation of an implied easement. The demand for an **easement by necessity** arises when property is **landlocked**. Access to and from a public roadway across all adjacent properties is denied in land locked property for the lack of the ability to create an easement by agreement or prior conduct.

Since public policy favors the productive use of land, an easement by necessity will be created when property is landlocked. [**Reese** v. **Borghi** (1963) 216 CA2d 324]

However, to establish an easement by necessity, the user must:

- show *strict necessity*; and
- defend against any claim that the property was **intended to be landlocked**.

Strict necessity requires the easement to be the only possible means of access. [**Zunino** v. **Gabriel** (1960) 182 CA2d 613]

Additionally, an easement by necessity lasts only as long as the necessity exists. Thus, if a public road is built or an existing adjacent road is dedicated to the public, an easement by necessity is terminated since the need is terminated.

No *time limitations* exist for bringing a quiet title action to establish an easement by necessity since the easement legally exists as long as the necessity exists.

Even if an easement is strictly necessary to access property (i.e., landlocked), an easement will not be created contrary to the intent of the original grantor dividing and transferring the parcel.

Chapter 45 Interference and termination of easements

This chapter reviews the ways in which an easement may be eliminated by an owner of property burdened by the easement.

For a further discussion of this topic, see Chapter 22 of Legal Aspects of Real Estate.

Chapter 45 Outline

Termination of easements
Release by deed to burdened property
Merger as an extinguisher
Extinguished by destruction of property
Forfeiture for exceeding authority
Prescription creates and destroys
Abandonment as never to use again

Chapter 45 Terms

Abandonment	*Forfeiture*
Destruction	*Merger*
Excessive burden	*Prescription*
Extinguished	*Release*

Termination of easements

An existing easement can be *extinguished*, and thus no longer affect the burdened property as an encumbrance on its title. Methods used to **extinguish** an easement include:

- *release* of the easement by a deed from the owner of the property holding the appurtenant right;
- *merger* by the acquisition of fee title to both the benefitting and burdened properties by the same owner;
- *destruction* of the burdened property which permanently prevents any further use of the easement;
- *forfeiture* due to the easement holder's abuse of his easement rights;
- *prescription* due to the burdened property owner's continuing interference with the easement; and

- *abandonment* by the conduct of the easement holder showing he does not intend to use his easement rights.

Release by deed to burdened property

An owner of property benefitting from the use of an easement may voluntarily terminate the easement by **releasing the easement** to the owner of the property burdened by the easement.

The release can be accomplished by the use of a quitclaim or grant deed in favor of the owner of the property burdened by the easement and signed by the owner of the property with the appurtenant right to use the easement.

Merger as an extinguisher

A **merger of legal interests** by common ownership of both the servient and dominant properties extinguishes an easement. A merger occurs when the same owner acquires fee title to both the benefitting and burdened properties.

Due to the fact that an owner cannot have an easement over his own property, the easement is automatically extinguished on the **common ownership** of both the properties. [Calif. Civil Code §805]

However, no merger occurs when the sole owner of burdened property acquires title to the benefitting property as a co-owner since the owner is not the sole owner of both properties. [**Cheda** v. **Bodkin** (1916) 173 C 7]

Additionally, acquiring a lien which encumbers either the benefitting or burdened property by the owner of the other property is not a merger of interests.

Extinguished by destruction of property

An easement is terminated by the **destruction** of the burdened property since nonexistence of the burdened property renders the use of the easement impossible.

Consider an easement to use a stairway in an adjoining building. When the building burns down, the easement is extinguished since the owner is not required to rebuild the stairway. [**Cohen** v. **Adolph Kutner Co.** (1918) 177 C 592]

Forfeiture for exceeding authority

An easement is terminated by **forfeiture** when the easement holder exceeds his authorized use of the easement by placing an *excessive burden* on the property encumbered by the easement.

Prescription creates and destroys

Just as an easement can be established by adverse use of another's property, an **easement** can be *extinguished* by the burdened property owner's use of the area within the easement which *permanently interferes* with his neighbor's ability to use the easement.

An adverse use for purposes of terminating an easement is any act by the burdened property owner which **permanently obstructs** the beneficial use enjoyed by the holder of the easement.

Abandonment as never to use again

An easement can also be terminated through **abandonment** by the easement holder. However, the easement holder must clearly indicate his intent to **permanently abandon** the easement.

The termination of an easement by abandonment is not easily established. The easement holder's actions must demonstrate a **clear intent** to abandon all future use of the easement.

Chapter 46 Covenants, conditions and restrictions

This chapter discusses enforceable covenants, conditions and restrictions (CC&R) provisions, and reservations and restrictions in grant deeds.

For a further discussion of this topic, see Chapter 23 of Legal Aspects of Real Estate.

Chapter 46 Outline

Recording restrictive covenants
Covenants limiting use are affirmative
CC&Rs and future owners
Unenforceable or unreasonable CC&Rs
Amending CC&Rs

Chapter 46 Terms

Affirmative covenant	*Negative covenant*
Amendment clause	*Personal covenant*
Constructive notice	*Running with the land*
Covenants, Conditions and Restrictions	*Successors*

Recording restrictive covenants

When developers subdivide land or airspace, they cut a plot of land into two or more horizontal or vertical sections, called *lots*, *parcels* or *units*. Having created a subdivision, developers place **restrictive covenants** on how the **lots** may be used by later owners, called *successors*.

Use restrictions are usually contained in a document called a *Declaration of Covenants, Conditions and Restrictions (CC&Rs)*. **CC&Rs** are typically recorded with the original subdivision map.

Recorded documents in the chain of title to a parcel of real estate place a buyer on *constructive notice* of their contents.

A prospective buyer of a home in a subdivision protects himself from unknowingly buying property burdened with unwanted restrictions by reviewing and approving (or disapproving) the preliminary title report (prelim). A prelim discloses the results of the title company's search of the property's title history.

The title company conducts the document search and prepares the prelim which functions as an offer to issue a title policy. As a customer service, they will supply copies of any CC&Rs of record on request.

Covenants limiting use are affirmative

A recorded restriction can **limit the use** of a property to a specific purpose (e.g., a school, railroad, highway, dwelling, irrigation system, etc.). This type of restriction is classified as an *affirmative covenant*.

Another type of recorded restriction prohibits identified uses of the property, classified as a *negative covenant*. For instance, a typical **negative covenant** prohibits the sale of alcoholic beverages or other activities otherwise allowed to take place on the property.

CC&Rs and future owners

Recorded CC&Rs bind future owners of the subdivided lots, a scheme referred to as covenants *running with the land*. For a covenant to **run with the land** and affect future owners, the restriction must **directly benefit** the property. Thus, all lots within the subdivision are burdened by the restriction. [Calif. Civil Code §1462]

Consider a restriction limiting the use of all subdivision lots to single family residences. The use restriction equally *benefits* and *burdens* each lot in the subdivision, assuring consistent and compatible use throughout the subdivision — a **benefit** with an advantageous effect on each property. Since it benefits every lot, the restriction **runs with the title** to each lot and affects all future owners. [**Miles** v. **Hollingsworth** (1919) 44 CA 539]

However, consider a subdivider who sells a beachfront lot while retaining ownership of the surrounding lots in the subdivision.

The grant deed conveying the beachfront lot to the buyer contains a use restriction, stating the buyer can only conduct a hotel or yachting clubhouse business on the lot.

The buyer, unable to develop the property for the purposes set out in the use restriction, sells the lot to a developer who plans to use the property for a ferry landing service, not a hotel or clubhouse.

The subdivider seeks to prohibit the developer from conducting a business which violates the restrictive use covenant in the recorded grant deed to the original buyer.

Can the subdivider enforce the covenant entered into by the original buyer and stop the developer from using the lot for a ferry service?

No! The use restriction provides **no benefit** to the beachfront lot since it merely imposes a burden on the original buyer who agreed to limit his use of the property. Also, enforcement of the restriction is further limited due to its lack of wording binding the buyer's **successors in interest** to the restrictive covenant.

The restriction is only enforceable as long as the buyer holds title. Thus, it is classified as a *personal covenant*. Since the restriction against use is a personal promise, it does not run with the land and cannot be imposed on the developer who reacquired title.

Unenforceable or unreasonable CC&Rs

Restrictions on selling, leasing or encumbrancing real estate may not unreasonably restrict the marketability of the property, even if the restriction is contained in a trust deed or lease agreement. [CC §711]

However, due-on-sale clauses contained in a trust deed are no longer controlled by California law and, under federal mortgage law, are enforceable on the transfer of any interest in the real estate, except:

- short-term leases up to three years not coupled with a purchase option; and
- intra-family transfers of one-to-four unit, owner-occupied residential property on the death of an owner or for equity financing. [12 Code of Federal Regulations §591.5(b)]

CC&Rs on the installation or use of a *solar energy system* are unenforceable if the restrictions significantly increase the cost of the system or decrease its efficiency by:

- resulting in more than a 20% increase in the installation cost of the system; or
- decreasing the operating efficiency of the solar system by more than 20%. [CC §714]

Amending CC&Rs

When circumstances affecting the use of lots in a subdivision have changed and the CC&Rs need to be altered, a provision for adding or removing covenants, called an *amendment clause*, usually exists in the originally recorded CC&Rs which establishes a procedure for making the change.

For example, a condominium association's CC&Rs usually can be amended by a majority or other percentage vote of the association members as set forth in the amendment clause in the association's CC&Rs. [**Diamond Bar Development Corporation** v. **Superior Court of County of Los Angeles** (1976) 60 CA3d 330]

Unlawful restrictive covenants in the CC&Rs for common interest developments (CIDs) can be removed from title under a program available through the California Department of Fair Employment and Housing (DFEH).

The DFEH's **Restrictive Covenant Identification Service** (RCIS) reviews deeds, declarations and CC&Rs sent to them by associations for CIDs to determine if they contain unlawful restrictive covenants, such as those based on race, color, religion, sex, familial or martial status, sexual orientation, disability, national origin or ancestry.

Upon receiving an application and the document containing the restrictive covenant in question, the DFEH reviews the language in the document. The DFEH then issues a written determination as to whether the identified language violates fair housing laws.

If the DFEH determines the language constitutes an unlawful restrictive covenant, the property owner may strike out the unenforceable language by recording a modification of the CC&Rs with the county recorder.

However, the RCIS procedure is not available to owners of individual units in a CID since the CID association must act on its own. The board of directors of a CID association is required to delete any unlawful restrictive covenants from its CC&Rs and governing documents without the need to first obtain either the approval of their owners or the DFEH. [CC §1352.5]

Title and Vesting

Chapter 47 — A deed as a transfer

This chapter covers the creation, delivery and voidablility of a deed.

For a further discussion of this topic, see Chapter 25 of Legal Aspects of Real Estate.

Chapter 47 Outline

A deed by any name is a grant
Creating a valid deed for conveyancing
A deed in writing, with exceptions
Enforcing an oral promise to convey
Title by claims of adverse possession
Grantor qualifications as capable
Grantor identification in deed
The grantee as any person
Words of conveyance for a fee or less
Describing the property conveyed
The grantor's signature

Chapter 47 Terms

Adverse possession	*Grant provision*
Common description	*Grantor*
Conveyance	*Grantee*
Constructive notice	*Leasehold estate*
Estate at will	*Life estate*
Execute	*Power of attorney*
Fee simple	*Quitclaim deed*

A deed by any name is a grant

Real estate is *conveyed* when title is transferred from one individual to another. [Calif. Civil Code §1039]

The transfer of title to real estate contained in a writing is called a *grant* or *conveyance*, no matter the form of writing. [CC §1053]

A *deed* is itself the **grant** which transfers title to property. [**Hamilton** v. **Hubbard** (1901) 134 C 603]

Title by deed passes either:

- *voluntarily* by agreement with the owner, as in a sale in the open market, or under a power of sale provision in a trust deed or the covenants, conditions and restrictions (CC&Rs) of a common interest development (CID); or
- *involuntarily* without agreement, as in the enforcement of a creditor's judgment or tax lien.

No matter the form of writing, the individual conveying real estate is called the *grantor*, and the individual acquiring title is called the *grantee*.

Fee simple ownership is presumed to pass by a grant of real estate, unless a lesser possessory interest is stated, such as an easement, life estate or leasehold interest, or a quitclaim deed is used. [CC §1105]

Ownership of *possessory interests* in real estate include:

- a fee simple;
- a life estate;
- a leasehold estate; and
- an estate at will. [See Chapter 29]

A **fee simple** interest in real estate is the absolute ownership of the possessory rights in the real estate for an indefinite duration.

Creating a valid deed for conveyancing

To be *valid*, a deed must:

- be in writing;
- identify the grantor and the grantee;
- contain a granting clause stating the grantor's intention to convey;
- adequately describe the real estate involved;
- be signed by the grantor; and
- be handed to and accepted by the grantee.

Form deeds used in real estate transactions conform to these validity requirements by containing words of conveyance, and contain provisions for the identification of the parties and a description of the real estate. They are also of suitable size and format to permit the deed to be notarized and recorded. [See **first tuesday** Form 405 and Form 404 accompanying this chapter]

A deed in writing, with exceptions

To be **valid**, the *transfer* of an ownership interest in real estate must be in writing, except for:

- an estate at will or a lease not exceeding one year [CC §1091];
- an *executed* (partially or fully performed) oral agreement under which the buyer takes possession of the property and makes payments toward the purchase price or makes valuable improvements on the property; or
- adverse possession.

An **executed oral agreement** for the transfer of real estate ownership will be enforced either under the doctrines of *specific performance* or *estoppel*. The application of both doctrines is unaffected by whether the property is being sold under an oral agreement to a buyer for consideration, or given to a **donee** by gift.

Enforcing an oral promise to convey

A buyer and seller who enter into an oral **land sales contract**. The buyer agrees to pay the purchase price by taking over payments on the first trust deed of record and making monthly payments to the seller.

The seller agrees to convey title to the buyer when the buyer has fully paid the purchase price, resulting in the satisfaction of the first trust deed and the complete payoff of the seller's equity in the land sales agreement.

The buyer takes possession of the property. The buyer eventually completes payment of all amounts due to the first trust deed lender and the seller under the land sales contract. Having fully performed the oral agreement, the buyer makes a demand on the seller to convey title to the property.

The seller refuses, claiming the oral land sales contract is unenforceable since the statute of frauds requires an agreement for the sale of real estate to be in writing to be enforceable.

Is the buyer entitled to the specific performance of the oral land sales contract and conveyance of title to the property?

Yes! The buyer's **possession** of the property and **full or partial performance** of the oral land sales contract collectively acts as a substitute for the prerequisite signed writing required by the statute of frauds for enforcement of a sale of real estate.

However, **partial payment** of the purchase price under an oral agreement when the buyer is not given possession is insufficient to overcome the statute of frauds writing requirement for an agreement transferring real estate.

The buyer must be given possession of the property for the oral purchase agreement to be enforceable on a partial payment. The buyer's **open and notorious** possession indicates a claim of ownership in the property which is inconsistent with the seller's claim of ownership when a verbal agreement for payment of the agreed-to price has been acted upon. [**Francis** v. **Colendich** (1961) 193 CA2d 128]

Additionally, the buyer's possession of the property is inconsistent with record title. Any purchaser obtaining title from the seller (or lender receiving a trust deed lien) after the buyer takes possession is on *constructive notice* to further inquire into the interest of the buyer-in-possession of the property.

The subsequent purchaser (or lender) will not be an innocent buyer who is without notice of the buyer-in-possession's interest, called a *bona fide purchaser* (BFP), since the purchaser (or lender) must inquire about the buyer-on-possession's interest when it appears inconsistent with the his recorded interest, if a recording exists. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

Title by claims of adverse possession

To establish title by *adverse possession*, an occupant must show:

- his possession is based on a *claim of right* or *color of title*;
- he has occupied the property in an open and notorious way which constitutes *reasonable notice* to the record owner;
- his occupancy is *hostile and inconsistent* with the owner's title;
- he has been in possession for a *continuous and uninterrupted period* of at least five years; and
- he has *paid all taxes* assessed against the property during his occupancy. [Calif. Code of Civil Procedure §§318 et seq.; see Chapter 44]

An occupant's ownership by **adverse possession** based on a **claim of right** avoids the statute of frauds requirement that agreements to transfer real estate must be in writing.

To obtain title by adverse possession based on a claim of right, the occupant has, by the nature of adverse possession, no written documentation or evidence of title. Essentially, the adverse possessor is a trespasser in possession of the owner's property without any bona fide (good faith) belief he holds title to the property. [**Brown** v. **Berman** (1962) 203 CA2d 327]

Thus, in the case of adverse possession by a claim of right, the owner of the property has not orally conveyed title to the real estate to the occupant. The occupant is a trespasser until his **conduct** and **time in possession** meet the requirements for him to obtain a court ordered transfer of title by adverse possession.

On the other hand, title by adverse possession based on a **color of title** usually occurs when the occupant's title is based on a defective deed.

Grantor qualifications as capable

A **grantor** of property must be *capable* of conveying an interest in real estate at the time the deed is signed for the deed to be enforceable as an actual conveyance of real estate. [CC §38; Calif. Family Code §6701]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

MAIL TAX STATEMENTS TO:

Name

Street Address

City & State

DOCUMENTARY TRANSFER TAX $______________

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area ______________________________

☐ City of ____,

____
(Signature of Agent determining tax)

GRANT DEED

Prepared by: Agent ___________________________ | **Phone** ______________________

Broker ___________________________ | **Email** ______________________

I/We, ____,
grant to ____
the real property in the City of ____,
County of ____, State of California,
referred to as ____
APN # ______________________

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____________, 20______ ___________________________ ___________________________
(Print Name) (Signature)

Date: _____________, 20______ ___________________________ ___________________________
(Print Name) (Signature)

STATE OF CALIFORNIA
COUNTY OF ______________________________________

On ______________________________________ before me,

____
(Name and title of officer)

personally appeared ________________________________

____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ______________________________________
(Signature of notary public)

____
(This area for official notarial seal)

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

FORM 404 03-11

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To be **capable**, the grantor at the time the deed is signed must:

- be of *sound mind*;
- possess his *civil rights*; and
- be *an adult* at least 18 years of age. [CC §1556]

However, an exception exists to the "18 or over" age qualification. An individual under the age of 18 is considered an adult as an *emancipated minor* if the individual:

- has entered into a valid marriage, even if the marriage is now dissolved;
- is on active duty with the United States armed forces; or
- has received a declaration of emancipation from the court. [Fam C §7002]

An **emancipated minor** is considered an adult capable of transferring an interest in real estate. [Fam C §7050(e)(3)]

Grantor identification in deed

The *grant provision* in a deed must identify each person who is conveying an interest in the property. If a conveyance such as a deed is signed by a person who is **not named as the grantor** in the grant provision in the deed, the deed does not convey that person's interest in the property. The identity of the grantor in the provision containing words of conveyance (grant) must be certain by an examination of the entire deed, not just the signatures. [**Childs** v. **Newfield** (1934) 136 CA 217]

For example, a deed identifies several individuals as grantors in a grant provision and the document contains their signatures. However, the list of grantors named in the deed's grant provision is incomplete and does not convey all the fee ownership of the property since several unnamed individuals also have an ownership interest in the property.

Further, the signatures on the grant deed include all the individuals who are co-owners of the property — even though some are not named as grantors in the grant provision.

In this instance, the deed transfers only the ownership and title held by those owners named as grantors in the grant provision in the deed. The deed by its wording does not show the necessary intent to convey title by the unnamed owners who were not listed as grantors but also signed the deed. [**Roberts** v. **Abbott** (1920) 48 CA 779]

On recording, the county recorder will only index as grantors those persons listed in the grant provisions since only they conveyed their interests in the real estate.

The grantee as any person

While the grantor must *have the capacity* to convey title, any existing person (individual or entity) may take and hold title to real estate as the *grantee.* [CC §671]

A child or an incompetent person has the *capacity to receive* and hold title as a grantee even though that person does not have the legal capacity to then convey the same property. [**Turner** v. **Turner** (1916) 173 C 782]

A deed must **identify** the grantee. For example, a seller accepts a buyer's purchase agreement offer. The seller concurrently signs a deed and hands it to the broker since the seller is leaving the country. However, the space for the name of the grantee is left blank. The broker is not instructed to enter the buyer's name as the grantee. The broker, as instructed, delivers the deed to the buyer without entering the buyer's name as the grantee.

Is the deed which does not name the grantee a valid transfer of title?

No! A deed which does not identify a grantee is void. The identity of the grantee must be sufficient to **identify with certainty** the individual to whom the seller intends title to be passed, such as by identifying the grantee as "the husband of the grantor." [**Tumansky** v. **Woodruff** (1936) 14 CA2d 279]

Additionally, a deed is considered valid if the individual identified as the grantee takes title under a *fictitious name* by which he is also known or has assumed for the purpose of receiving title.

However, if the fictitious name is established for the purpose of committing a fraud against the grantor, the grantor may set aside the deed as **voidable**.

A deed to a person who does not exist, referred to as a *fictitious person*, or to a person who is dead at the time of conveyance, or to a corporation, limited liability company (LLC) or partnership which does not legally exist, will not convey title since no one exists to accept delivery. [**McWhorter** v. **McWhorter** (1929) 99 CA 293]

Sometimes an unintentional error **misnames the grantee** in a recorded deed, such as by misspelling the grantee's name. A deed with a misnamed grantee is still a valid conveyance of the real estate.

Another deed from the same grantor to the grantee named with the correct spelling of the grantee's name will not correct the error, nor will re-recording the original deed with an amendment containing the grantee's correct name. The recording of a corrective deed falls outside the chain of title in the grantor-grantee index since the grantor no longer has any interest to convey. The grantor has already conveyed his title, albeit to a grantee with an erroneously spelled name. [**Walters** v. **Mitchell** (1907) 6 CA 410]

Figure 1

Example of the reference in a deed to the description of property located in other documents:

Lot 30 of the Sherman Tract #3 as per map recorded in Book 34, pages 72 of maps, records of Riverside County, California.

A grantor who has conveyed title cannot do so again even as an attempt to convey title to the same grantee.

Editor's note — Title companies are only concerned the grantor on a deed is the same person who took title under the incorrect name. Title companies will generally accept a deed conveying title which identifies the grantor by both his correct name and the incorrect (misspelled) name under which he originally took title as a grantee.

Words of conveyance for a fee or less

The actual words of conveyance in a deed depend on whether the deed used is a *grant deed* or a *quitclaim deed*. [See Chapter 49]

A **grant deed** is used to pass a *fee simple interest* in real estate from the grantor to another individual, unless a lesser interest is stated in the deed. While no precise words of conveyance are necessary, use of the word "grant" in the granting clause, without noting a lesser interest in the description of the property, indicates the conveyance of a fee simple interest in the described property. [See Form 404]

Alternatively, a **quitclaim deed** is intended to convey whatever interest, if any, the grantor may hold in the real estate. The words of conveyance historically used in a quitclaim deed are "remise, release and otherwise quitclaim."

However, only the word "quitclaim" is required as the word of conveyance. The word "grant" is not used in a quitclaim deed since no implied warranties are included with a conveyance under a quitclaim deed. However, the parties to a quitclaim deed are referred to as the "grantor" and the "grantee." [See **first tuesday** Form 405]

Describing the property conveyed

A deed conveying property must sufficiently describe the property being conveyed so it can be reasonably located from the description in the deed. If the property cannot be located from the description in the deed, the conveyance is void. [**Scott** v. **Woodworth** (1917) 34 CA 400]

Extrinsic evidence, facts not stated in the deed, may only be used when an **ambiguity** arises as to the description of the property conveyed.

However, extrinsic evidence may not be used to supply the deed with a missing description or correct a defective description.

The description of a parcel in a deed must be sufficient to allow the real estate conveyed to be identified and located with reasonable certainty by a surveyor. [**Best** v. **Wohlford** (1904) 144 C 733]

For example, real estate is conveyed by a deed describing the property as the "Occidental Mill Site, containing 4.95 acres, being a fraction of lot 2..." The use of the real estate's common name in the deed is sufficient to locate the boundaries and identify the real estate being conveyed. [CC §1092]

*Editor's note — Any dispute regarding the location of the 4.95 acres on lot 2 must be resolved as a **boundary dispute.***

Additionally, a deed which describes real estate by its street address, such as "879 Riverside Avenue, Riverside, CA 92507," will be considered sufficient to identify the real estate located at the street address, sometimes called a *common description* or *common address*. [**Brudvig** v. **Renner** (1959) 172 CA2d 522]

However, the deed should include the property's legal description (metes and bounds) or a map designation, such as a parcel or lot number, which contains the **metes and bounds** description needed to locate with certainty the parcel being conveyed.

Thus, the real estate can be described by reference to other documents, such as a subdivision map which contains the metes and bounds description of the parcel. The document referenced in a deed is incorporated into the deed as the source of the metes and bounds description of the property conveyed. [**Edwards** v. **Lewis** (1938) 25 CA2d 168; see Figure 1]

The grantor's signature

To transfer real estate by a deed, the deed must be signed by the grantor named in the deed. [CC §1091]

A deed can also be signed on behalf of the grantor by the **grantor's agent** if the agent is authorized in writing to convey the property on the grantor's behalf. The agent is called an *attorney in fact* and is operating under a *power of attorney.* [CC §1091; see Chapter 40]

Additionally, a deed can be signed in the name of the grantor by an *amanuensis* as orally instructed by the grantor. An **amanuensis** is an individual who has the oral authority of the grantor to sign a grant deed by his own hand on behalf of the grantor.

Unlike an **attorney in fact** who is an agent with **discretionary authority** to determine whether he is to enter into a deed without prior approval from the grantor, an amanuensis has a purely ministerial duty and signs a document as instructed without exercising his personal discretion or judgment.

Editor's note — For a discussion on the differences between grant deeds and quitclaim deeds, see Chapter 49.

Chapter 48 — Delivery, acceptance and validity of deeds

This chapter discusses the intent necessary for a deed to be considered an enforceable conveyance which will withstand claims it is void or voidable.

For a further discussion of this topic, see Chapter 26 of Legal Aspects of Real Estate.

Chapter 48 Outline

Chapter 48 Terms

Acceptance	*Testamentary documents*
Constructive delivery	*Void deed*
Delivery	*Voidable deed*
Documentary transfer tax	

A recording is not necessary

A deed conveying real estate **transfers ownership** to the named grantee when the deed is *delivered*. The mere signing of a deed by the owner as the grantor, naming another person as the grantee to become the owner, is not enough to divest the owner of his title to the interest he holds in the real estate. Delivery of the signed deed is required to transfer ownership.

Delivery refers to two separate acts:

- the grantor's present **intent to convey title**, not just the act of physically handing the deed to the grantee; and
- the grantee's **acceptance** of the grant deed as an immediately effective conveyance.

While the grantor may intend to convey title when he hands over the deed, if the grantee **does not accept** the deed, the deed will not be considered delivered and a conveyance does not occur.

However, the grant deed does not need to be recorded to deliver title to a new owner or to revest title in two or more persons. Recording only *perfects* the ownership against third-parties, such as unknown off-record interests or later buyers, tenants and encumbrancers of the property.

Constructive delivery inferred

The delivery of a deed is *inferred* when the grantee receives or has **possession** of the deed. The deed may also be considered delivered without the grantee having or holding actual possession of the deed.

Even if the grantee does not have possession of the deed, the deed is not necessarily considered void as never having been delivered. When a grantee is not physically handed the deed, a *constructive delivery* of the deed may still have taken place.

Constructive delivery of a deed to the grantee is deemed to have occurred if:

- the deed is understood by the grantor and the grantee to be delivered by an agreement between them when the grantor signs the deed; or
- the deed is delivered to a third party for the benefit of the grantee, and the grantee or an agent of the grantee demonstrates the grantee's acceptance of the deed, or acceptance may be presumed. [Calif. Civil Code §1059]

Grantor's intent to convey

Without an owner's present *intent to convey* title as a grantor, a deed will not be considered delivered, even if the grantee is handed the grant deed and accepts physical possession of the deed.

Consider an owner who hands a grantee a deed as a gift. However, the owner orally advises the grantee that the deed is not to be effective until the owner dies, and if the grantee dies first, the deed must be returned to the owner. The owner of the real estate does not intend for the deed to be a present transfer of the ownership of the real estate to the grantee.

The owner dies and the grantee records the deed. Heirs of the owner assert they own the real estate, claiming the deed was not delivered and is invalid since the owner did not intend for the deed to convey ownership at the time the deed was handed to the grantee.

The grantee claims the deed is a valid conveyance of the real estate since delivery took place when the owner personally handed him the deed and he accepted it, subject to the condition of a delayed transfer.

Was the deed a valid conveyance of the real estate?

No! To be a *valid delivery*, both the owner and the grantee must **intend** for title to the real estate to be **conveyed concurrent** with the handing of the deed to the grantee. The owner of the real estate must intend for the document used to convey the real estate to operate as a deed which **immediately divests** the owner of title.

Since the owner intended the deed to become operative only on his death, as evidenced by the his actions and statements when the deed was handed to the grantee, the deed is considered an improper probate avoidance device, and is void, conveying nothing.

A deed handed to the grantee cannot act as a will or revocable inter vivos (living) trust agreement to transfer property on the death of the owner.

A will and an inter vivos trust agreement are *testamentary documents* which take effect after they are signed, on the owner's death. Upon entering into a will or trust agreement, the owner does not give up control or ownership until his death.

Conversely, a deed is a document used to **immediately pass** fee simple title (or other estate) on recording or the grantee taking possession of the deed. If the grantor does not intend to pass fee simple (or other estate) on handing the deed to the grantee, no actual delivery takes place and the deed is void. [**In re Estate of Pieper** (1964) 224 CA2d 670]

Grant deed as a mortgage-in-fact

Usually a grant deed is used with the intent to pass full legal title to the described property when it is handed to the grantee or recorded by the grantor.

However, when a grant deed is intended to convey title to a lender as *security* for the repayment of a debt he owes, in spite of its wording of conveyance, the grant deed does not transfer the right of ownership.

A grant deed given to provide a creditor with the property as **security** (collateral) is a *mortgage-in-fact*. Thus, a *lien* is imposed on the property in favor of the lender, similar to a trust deed lien.

Brokers and their agents who arrange loans should always use a trust deed as the device which attaches the debt as a lien on real estate. Using a grant deed as a security device is improper practice. A grant deed is generally equated to the grantor's intent to convey all rights and title in the property to the named grantee.

A trust deed does not convey any ownership rights in the property to the lender. Rather, a trust deed imposes a lien on the property in favor of the lender to secure the owner's performance of a money obligation owed the lender. On executing a trust deed, the owner retains all ownership rights to the secured property, which is the intent when using a trust deed.

Acceptance by the grantee

A grantee is *presumed* to have accepted a deed if the grant is beneficial to the grantee.

For example, an owner of real estate deposits in an escrow, or with a broker or other agent of the owner, a deed conveying real estate to the named grantee. The owner's written instructions accompanying the deed state the deed is to be delivered to the grantee on the owner's death. The owner will continue to occupy the property.

The instructions contain no provisions for the owner's withdrawal of the deed from escrow. Thus, the owner retains no power to revoke the deed. However, the grantee is not aware of the existence of the grant conveying title to the real estate.

On the owner's death, escrow delivers the deed to the grantee as instructed.

Is the deed considered valid even though the grantee, being unaware of the deed, did not formally accept it?

Yes! The delivery of the deed to a third party, such as an escrow or someone else acting as the owner's agent, with instructions to deliver the deed to the grantee on the owner's (grantor's) death is considered *constructive acceptance* by the grantee — even though the deed's existence was unknown to the grantee.

The conveyance of the property was for the grantee's benefit and thus the deed was **presumed** to have been accepted by the grantee when the deed was **conditionally delivered** to a third party. [**Windiate** v. **Moore** (1962) 201 CA2d 509]

Additionally, a deed is **presumed to be accepted** and the conveyance complete if the deed is:

- physically handed to the grantee [**California Trust Co.** v. **Hughes** (1952) 111 CA2d 717];
- recorded by the grantee [**Drummond** v. **Drummond** (1940) 39 CA2d 418]; or
- in the grantee's possession. [California Trust Co., *supra*]

Recording the grant deed

To convey real estate, the deed does not need to be recorded. A deed that is delivered conveys an interest in real estate even when the deed is **incapable of being recorded**.

A deed only needs to be recorded to put future buyers or encumbrancers on notice of the transfer. Recording the deed *perfects ownership* of the interest conveyed against others who might later claim an ownership, security or leasehold interest in the property.

A deed **capable of being recorded** with the county recorder must include:

- **identification** of the person requesting the recording, and the person to whom the document will be returned by the county recorder as indicated at the top left hand corner of the deed [Gov C §27361.6]; and
- the **address** where and to whom tax statements are to be sent by the county tax collector, indicated at the bottom of the first page. [Gov C §27321.5]

Failure to identify the person requesting the recording of the deed, where the deed is to be sent after recording, or where the local real estate tax statements are to be sent does not affect the validity of the deed or the *constructive notice* to others implied by recording the deed. [Gov C §§27321.5, 27361.6]

The deed submitted for recording must also include the amount of the *documentary transfer tax* to be paid. The deed will not be recorded by the recorder unless the **documentary transfer tax** is paid at the time of the recording. An additional transfer tax may be charged by the city, county or both the city and the county. [Calif. Revenue and Taxation Code §§11901 et seq.]

Once recorded, a deed constitutes a change of ownership which subjects the property to reassessment. Thus, the deed should be accompanied by a **change of ownership statement** which the recorder hands to the county assessor. [Gov C §27280; Rev & T C §480]

If the deed submitted to the county recorder does not include a change of ownership statement, the recorder will record the document and either:

- include a change of ownership form with the return of the recorded deed; or
- provide the assessor with the identification of the recorded document which was not accompanied by the change of ownership statement. [Gov C §27321]

Additionally, a **notary public acknowledging** an individual's signature on a deed affecting the title to real estate, such as a grant deed, quitclaim deed or trust deed, will require the individual to place his thumbprint in the notary's journal. The **thumbprint requirement** does not apply to the recording of a trustee's deed or a reconveyance of a trust deed. [Gov C §8206(a)(2)(G)]

Void vs. voidable deeds

Void and *voidable* are terms which seem similar but are distinguishable by the date they affect the validity of a deed, and thus, the rights of those who relied on the deed.

Void deeds are unenforceable and never convey an interest in real estate at any time, a concept called *void ab initio* — without legal effect from the beginning.

If title is claimed under a void deed, any claim of ownership under the deed must fail, even if a further grantee purchases the property in good faith without any notice of a defect in title or in the deed held by the grantor.

Examples of **void deeds** include:

- a deed signed and delivered by a seller under the age of 18 — due to legal *incapacity* [Calif. Family Code §6701];
- a deed handed directly to the grantee with the intent it is not to be effective until the owner's death — conditional delivery to the grantee, not to a third party [Estate of Pieper, *supra*];
- a deed materially altered without the grantor's consent [**Tannahill** v. **Greening** (1927) 85 CA 714]; or
- a forged deed. [**Meley** v. **Collins** (1871) 41 C 663]

Voidable deeds

A **voidable deed**, unlike a void deed, is a deed which is *valid and enforceable* after delivery until it is challenged due to a defect and a court order declares the deed to be invalid.

Examples of **voidable deeds** include:

- a deed obtained through **false representations**, such as a grantee who acquires title at a trustee's sale by advising the owner he has superior knowledge concerning the property's title condition and then misrepresents the condition of title, inducing the owner to allow the property to be sold by foreclosure [**Seeger** v. **Odell** (1941) 18 C2d 409];
- a deed obtained through **undue influence** or threat, such as imprisoning or restraining the owner until he signs a grant deed [**Campbell** v. **Genshlea** (1919) 180 C 213]; or
- a deed from a grantor of **unsound mind**, but not entirely without understanding, made before the grantor's incompetency to convey has been adjudicated. [CC §39]

Unlike void deeds, a voidable deed is enforceable by a bona fide purchaser (BFP) or encumbrancer who relies on the title held by the grantee under a voidable deed which has not yet been challenged as invalid.

Chapter 49 — Grant deed vs. quitclaim deed

This chapter presents the two most common types of deeds used to convey property interests and their characteristics.

For a further discussion of this topic, see Chapter 27 of Legal Aspects of Real Estate.

Chapter 49 Outline

The granting clause
Grant deed covenants are implied
Quitclaim deeds: you have what I had
After-acquired title and quitclaims
Judicial sales and sheriff's deed

Chapter 49 Terms

Assignment clause	*Quitclaim deed*
Estopped	*Release*
Inchoate right	*Warranties*
Grant deed	

The granting clause

The two types of deeds commonly used to convey a real estate interest are:

- *grant deeds* [See **first tuesday** Form 404 in Chapter 47]; and
- *quitclaim deeds*. [See Form 405 accompanying this chapter]

To pass a fee simple interest in real estate, only the word "grant" needs to be used in the conveyance. No other precise words of conveyance are necessary in a deed to convey a fee simple ownership. [Calif. Civil Code §1092]

The word "grant" contained in the conveyance provision in a grant deed indicates the conveyance of a fee simple interest to another individual, unless the deed states a lesser interest is conveyed. [See **first tuesday** Form 404 in Chapter 47]

A **quitclaim deed** customarily uses the words "remise," "release" or "quitclaim," but does not contain the word "grant." However, only the word "quitclaim" needs to be used to convey all interest held in the property by the grantor. [See Form 405]

A quitclaim deed conveys only the grantor's interest in a property, if any exists. A quitclaim deed can also be used in lieu of a grant deed to pass fee simple in the described real estate.

The words used to convey property are evidence of the **future role** the individual conveying title undertakes after the deed has been signed and delivered. Thus, to convey real estate with **covenants** relating to the interest conveyed, a grant deed is used. To simply convey any interest in real estate without an assurance the individual holds that interest conveyed, a quitclaim deed is used.

Grant deed covenants are implied

The covenants, sometimes called *warranties*, implied in a grant deed include:

- the interest conveyed in the real estate has not been *previously conveyed* to another, except as disclosed in the grant deed; and
- the real estate has not been *further encumbered* by the grantor, except as disclosed in the grant deed. [CC §1113]

Grant deed covenants are **implied**. Thus, they are not separately bargained for as provisions to be included in the grant deed conveyance.

If a grant deed covenant is breached by a seller (grantor), the buyer (grantee) may recover his money losses from the seller for the breach of the implied covenant, as though the covenant had been written into the grant deed. [CC §1113]

Quitclaim deeds: you have what I had

A *quitclaim deed* terminates any interest in the real estate described in the deed which may be held by the person (grantor) signing and delivering the quitclaim deed. [See Form 405]

Unlike a grant deed, a **quitclaim deed** does not carry with it the implied covenants contained in a grant deed. A quitclaim deed operates to **release to the grantee all interest** the grantor may hold in the property. [**Platner** v. **Vincent** (1924) 194 C 436]

A quitclaim deed passes whatever title, legal or equitable, the grantor possessed on execution (signing and delivering) of the quitclaim deed.

While a quitclaim deed is not intended to assure the conveyance transfers full fee simple ownership, the individual who **holds fee title** and signs and delivers a quitclaim deed does convey fee simple ownership of the property, and all the benefits of holding fee simple title. [**Spaulding** v. **Bradley** (1889) 79 C 449]

After-acquired title and quitclaims

Unlike a grant deed, a quitclaim deed does not also pass the grantor's after-acquired title to the real estate described in the quitclaim deed. The quitclaim deed is a *release* of the grantor's interest in the real estate at the time it is signed and delivered.

The individual signing and delivering a quitclaim deed does not promise to convey an interest in the real estate, much less agree he has received it (seisin) and not previously conveyed or encumbered it (implied covenants).

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDERS USE

MAIL TAX STATEMENTS TO:

Name

Street Address

City & State

DOCUMENTARY TRANSFER TAX $______

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area ______

☐ City of ______, and

______
(Signature of Agent determining tax)

QUITCLAIM DEED

Prepared by: Agent ______ Phone ______
Broker ______ Email ______

I/We, ______,
quitclaim to ______
the real property in the City of ______,
County of ______, State of California,
referred to as

☐ See attached Signature Page Addendum. [ft Form 251]

Date: ______, 20____ ______ (Print Name) ______ (Signature)

Date: ______, 20____ ______ (Print Name) ______ (Signature)

STATE OF CALIFORNIA
COUNTY OF ______
On ______ before me,
______
(Name and title of officer)
personally appeared ______
______,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ______
(Signature of notary public)

(This area for official notarial seal)

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

FORM 405 03-11

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However, after-acquired title will pass to a buyer named in a previous quitclaim deed if:

- the seller sold by use of a quitclaim deed an *unperfected right* in the property which will later ripen into ownership, called an *inchoate right*, such as the interest held by a beneficiary under a will or inter vivos (living) trust prior to the death of the property owner [**Soares** v. **Steidtmann** (1955) 130 CA2d 401]; or
- the seller is *estopped* (barred) by his sales agreement or his conduct from claiming the after-acquired title does not pass to the buyer.

The seller is **estopped** from claiming the after-acquired title does not pass if:

- the quitclaim deed contains recitals or covenants, such as an *assignment clause*, showing the seller's intention was not to limit the interest conveyed to only the interest the seller had at the time the quitclaim deed was executed; or
- the seller has affirmed, or his conduct has implied, he actually had an interest in the property which was to be conveyed. [**In re Wilson's Estate** (1940) 40 CA2d 229]

Judicial sales and sheriff's deed

Deeds executed by agents of the court, such as a receiver or sheriff, to transfer title under a judicial foreclosure sale, an execution sale or other court-ordered sale are similar to quitclaim deeds in that none of these carry with them the *implied covenants* of a grant deed. Only an owner's interest in a property, if any exists, which was subject to the judicially ordered sale is conveyed. Likewise, any after-acquired title later acquired by the owner in the property sold by judicial order does not later pass to the buyer.

A sale is considered judicial if the property is conveyed by an order of the court to carry out a judgment, such as a sale on the execution of a money judgment or a judicial foreclosure sale. [**In re Backesto's Estate** (1923) 63 CA 265]

Additionally, a buyer and broker at a judicial foreclosure sale have the responsibility to investigate and determine the condition of the property, and the ownership interest and condition of the owner's title being conveyed by order of the court, since *no warranties exist*. [Mains, *supra*]

Chapter 50 — Preliminary title reports

This chapter examines the use of a preliminary title report by a buyer to review the condition of title before allowing contingency provisions in purchase agreements to expire, and by escrow to prepare closing documents.

For a further discussion of this topic, see Chapter 28 of Legal Aspects of Real Estate.

Chapter 50 Outline

An offer to insure a policy
Prelim vs. abstract of title

Chapter 50 Terms

Abstract of title	*Encumbrance*
Abstractor's liability	*Preliminary title report*

An offer to insure a policy

A preliminary title report typically discloses the current vesting, as well as the general and special taxes, assessments and bonds, covenants, conditions and restrictions (CC&Rs), easements, rights of way, encumbrances, liens and any interests of others which may be reflected on the public record as affecting title, collectively called *encumbrances*.

A preliminary title report is not a representation of the condition of title or a policy of title insurance. Unlike an *abstract of title*, a prelim cannot be relied on by anyone.

A title insurer has no duty to accurately report title defects and encumbrances on the preliminary title report (shown as exceptions in the proposed policy). [**Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181]

A preliminary title report is no more than an **offer to issue** a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued. [Calif. Insurance Code §12340.11]

The closing of many purchase escrows is conditioned on the buyer's approval of the prelim. The buyer, his agent and escrow review the report on its receipt for defects and encumbrances on title inconsistent with the terms for the seller's delivery of title in the purchase agreement and escrow instructions.

Buyer's agents in a sales transaction check the prelim prior to closing for title conditions. Buyers' agents are looking for title conditions which might interfere with any **intended use or**

change in the use of the property contemplated by the buyer. Interferences could be in the form of unusual easements or use restrictions which obstruct the buyer's announced plans to make improvements.

Finally, escrow relies on the prelim to carry out its instructions to record grant and trust deeds, leaseholds, or options which will be insured.

Typically, escrow instructions call for closing when the deed can be recorded and insured, subject only to taxes, CC&Rs and other encumbrances specified in the instructions.

Ultimately, it is the escrow officer who, on review of the prelim, must advise the seller of any need to eliminate defects or encumbrances on title which interfere with closing as instructed.

The prelim and a last-minute date-down of title conditions are used by escrow to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents being recorded (deeds, trust deeds, etc.).

Should the date-down of the prelim reveal defects or liens not previously reported in the prelim, either by error or by later recording, the title company can **withdraw its offer** under the prelim and issue a new prelim, an offer to issue a policy on different terms.

Prelim vs. abstract of title

Title companies have long been aware of the public's reliance on the prelim. This reliance was consistently reinforced by the California courts which held title companies liable for their erroneous reports. However, legislation drafted by the title insurance industry was introduced and enacted in 1981 to eliminate liability for their preparation of faulty preliminary title reports.

Prelims were once compared to abstracts of title. An **abstract of title** is a written statement which may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered or leased. [Ins C §12340.10]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on liability set by the policy. Since the content of an abstract is intended by the insurance company to be relied upon **as fact**, the insurer is liable for all money losses of the policy holder flowing from a failure to properly prepare the abstract. [**1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992]

In an effort to shield title companies from an *abstractor's liability* on the issuance of a defectively prepared prelim, the prelim has been legislatively redefined as being neither an abstract of title nor a representation of the condition of title. The prelim is now defined as a report furnished in connection with **an application** for title insurance. [Ins C §12340.11]

The prelim has become and is simply an **offer** by a title company to issue title insurance. The prelim is merely a statement of terms and conditions on which the title company is willing to issue a policy — subject to last minute changes prior to issuing the policy of title insurance.

Chapter 51 — Title insurance

This chapter reviews title insurance and presents the distinguishing features of the different types of policies available.

For a further discussion of this topic, see Chapter 29 of Legal Aspects of Real Estate.

Chapter 51 Outline

Identifying an actual loss
Encumbrances unknown, undisclosed
Property improvement and use not covered
Underwriting only indemnifies a loss
Introduction to title policy forms
Insuring clauses
Exclusions from coverage
Schedule A data
Exceptions to coverage
Claims and settlements
Owner's policies for buyers
The CLTA standard policy
The ALTA owner's policy and survey
The ALTA residential policy
The ALTA homeowner's policy
The CLTA standard JP policy
The ALTA loan policy increases costs
Who is insured?
Settling a claim
Extent and limitation of liability

Chapter 51 Terms

American Land Title Association	*Joint protection policy*
California Land Title Association	*Policy exceptions*
Encumbrance	*Public records*
Future advances	*Schedule A*
Indemnification	*Settlement*

Identifying an actual loss

A policy of title insurance is the means by which a title insurance company *indemnifies* — reimburses or holds harmless — a person who acquires an interest in real estate against a monetary loss caused by an **encumbrance on title** that:

- is not listed in the policy, which if listed is called an *exception*; and
- the insured was unaware of when the policy was issued. [Calif. Insurance Code §12340.1]

A policy of title insurance is issued on one of several prototypical forms which are used by the entire title insurance industry in California. The policies are typically issued to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by real estate.

As an **indemnity agreement**, a title insurance policy is a contract. The terms of coverage in the policy set forth the extent of the title insurance company's obligation, if any, to indemnify the named insured for a *money loss* caused by an **encumbrance on title** which is not listed in the policy's *exceptions*. [Ins C §12340.2]

For example, a lender acquires a note secured by a trust deed on real estate. The encumbrances listed as **exceptions** in the lender's policy of title insurance do not include a tax lien which encumbers the property and has priority over the lender's trust deed lien. The lender later discovers the existence of the tax lien.

The lender satisfies the tax lien, forecloses and obtains title by a **full credit bid**. The amount bid includes advances for the tax lien. The lender sells the property at a price in excess of the credit bid and resale costs. The lender makes a demand on the title company under its title insurance policy for the amount of the tax lien claiming the lien reduced the lender's profits on the sale. The title company denies the claim.

In this example, the insured lender cannot recover the **reduction in profits** due to an unlisted defect in title since lost profits are not covered by title insurance. The title insurance policy only indemnifies the insured against a **reduction in the value** of the property below the policy limits, not a reduction in future profits on either a foreclosure or resale of the property. [**Karl** v. **Commonwealth Land Title Insurance Company** (1993) 20 CA4th 972]

Encumbrances unknown, undisclosed

Almost all losses due to the reduction in the value of real estate below the policy limits arise out of an *encumbrance*. An **encumbrance** is any condition which affects the ownership interest of the insured, whether the interest insured is a fee, leasehold, life estate or the security interest of a lender.

The word "encumbrance" is all encompassing. Any right or interest in real estate held by someone other than the owner which diminishes the value of the real estate is considered an encumbrance.

Encumbrances on title include:

- covenants restricting use;
- restrictions on use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;
- pendency of condemnation; and
- leases. [**Evans** v. **Faught** (1965) 231 CA2d 698]

Property improvement and use not covered

Physical conditions on the property itself are not encumbrances which affect title since they are uses which exist and are visible (open and notorious) on the property, such as:

- canals;
- highways;
- irrigation ditches; and
- levees.

Accordingly, title insurance policies do not insure against open and notorious physical conditions which exist on the property, since these observable physical conditions are not encumbrances.

Underwriting only indemnifies a loss

A title insurance policy is not an *abstract of title*. Thus, a policy of title insurance does not *warrant* or *guarantee* the nonexistence of title encumbrances, as does an **abstract of title**. Instead, the insured is *indemnified* up to the **policy's dollar limits** against a money loss caused by a title condition (encumbrance) not listed as an exception or exclusion in the policy.

Under a title insurance policy, the title company only assumes (covers) the risks of a **monetary loss** caused by an encumbrance which is not listed as an exception to coverage, and was unknown to the insured buyer or lender at the time of closing. The title company has no obligation to clear title of the encumbrance.

A title insurance company issuing a preliminary title report or a policy of title insurance has two underwriting options when its title search reveals an encumbrance affecting title:

- list the encumbrance in a preliminary title report, requiring the parties to the transaction to either eliminate it or accept it as an *exception* to coverage in the policy of title insurance to be issued; or

- insure against the encumbrance by *writing over* the encumbrance — i.e., not listing it as an exception — and assuming any risk of loss connected to it.

When title companies **write over** a known encumbrance, they usually demand an indemnity agreement from the person responsible for eliminating the encumbrance — typically a money lien, such as a mechanic's lien, money judgment or blanket encumbrance. Thus, the title company can recover if a claim by the insured is later paid due to the encumbrance.

Additionally, a title policy is not a representation of the nonexistence of encumbrances that are not excluded or listed in the policy. If an encumbrance (unknown to the buyer or lender prior to closing) does exist and is not listed as an exception in the policy, a claim against the insurer in excess of the policy limits cannot be based on the insurer's *negligent preparation* of the list of encumbrances excluded from coverage in the title insurance policy. Also, a claim on an erroneous preliminary title report (prelim) cannot be based on the negligent preparation of the report. [See Chapter 50]

However, a title insurer might *intentionally write over* encumbrances at the request of a seller. If the buyer is not notified the encumbrance exists, the insurer is liable for actual losses in excess of the policy coverage for breach of the implied covenant of good faith and fair dealing imposed on title companies as a duty owed to their insured, the buyer. [**Jarchow** v. **Transamerica Title Insurance Company** (1975) 48 CA3d 917]

Introduction to title policy forms

Title insurance is purchased to assure real estate buyers, tenants and lenders the **interest in title** they acquire is what they bargained for from the seller, landlord or borrower. While title insurance is not a guarantee of the condition of the interest acquired in title, it does provide a **monetary recovery** up to the policy's dollar limits for the conveyance of any lesser interest than the interest insured due to unlisted exceptions.

On closing a real estate transaction, a policy of title insurance is issued on one of several prototypical forms used throughout the entire title insurance industry in California. The policies are typically issued to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by the real estate.

Two basic forms exist which are the industry standard for:

- insuring the condition of record title only, accomplished by the issuance of a *California Land Title Association (CLTA) policy*; and

- insuring both the record title and observable on-site activities which affect title, accomplished by the issuance of an *American Land Title Association (ALTA) policy*.

A **policy of title insurance** is broken down into six operative sections, including:

- the **risks of loss covered**, called *insuring clauses*, which are based on a completely unencumbered title at the time of the insured transfer;
- the **risks of loss not covered**, comprised of encumbrances arising after the transfer or known to or brought about by the insured, called *exclusions*, which are a boilerplate set of title conditions;
- **identification** of the insured, the property, the vesting, the estate in the property, the dollar amount of the coverage, the premium paid and the policy (recording) date for the conveyance insured, called *Schedule A*;
- the **recorded interests**, i.e., any encumbrances affecting title and any observable on-site activities which are **listed as risks** agreed to and assumed by the insured and not covered by the policy, called *exceptions*, which are pre-printed for CLTA coverage and itemized for all types of coverage in *Schedule B*;
- the **procedures**, called *conditions*, for **claims made** by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title which is not an exclusion or exception to the coverage initially granted by the insuring clauses; and
- any **endorsements** for additional coverage or removal of exclusions or pre-printed exceptions from the policy

Insuring clauses

Coverage under the broadly worded **insuring clauses** of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

Exclusions from coverage

All title insurance policies, in their **exclusions section**, eliminate from coverage those losses incurred by the insured buyer, tenant or lender due to:

- **use ordinances** or (zoning) laws;
- **unrecorded claims known** to the insured, but not to the title company;
- encumbrances or adverse **claims created** or attaching **after** the date of the policy;
- claims arising out of **bankruptcy** laws or due to a **fraudulent conveyance** to the insured;

- police power and **eminent domain**; and
- **post-closing events** caused by the insured.

Schedule A data

All policies of title insurance on **Schedule A** set forth:

- the property interest the insured acquired (fee simple, leasehold, life estate, security, etc.);
- the legal description of the insured property;
- the date and time the insured conveyance or lien recorded and coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

Exceptions to coverage

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by **Schedule B** exceptions in the policy. The **exceptions section** contains an itemized list of recorded and unrecorded encumbrances which are known to the title company and affect the insured title. While the existence of these known encumbrances are insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

In addition to the itemized **list of exclusions**, an American Land Title Association (ALTA) policy includes a set of pre-printed exceptions setting forth risks assumed by the insured buyer, tenant or lender, which include:

Figure 1 *Excerpt from first tuesday's Form 150*
Purchase Agreement - One-to-Four Residential Units

12.4 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by ________________________________ title company on ☐ a Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements ____
b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

Scan this QR-Code for a PDF of the Form!

- taxes, assessments, liens, covenants, conditions and restrictions (CC&Rs), or any other interests, claims or encumbrances which have not been recorded with the county recorder or tax collector on the date of closing;
- any unrecorded and observable on-site activity which includes conflicts regarding boundary lines, encroachments or any other facts which a correct survey would disclose;
- unpatented mining claims; and
- all water rights.

Claims and settlements

Lastly, a policy of title insurance includes a **conditions section** which outlines the procedures the named insured must follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before they must pay a claim.

Owner's policies for buyers

Several types of title coverage are available for a buyer to choose from when entering into a purchase agreement with the seller, including:

- a California Land Title Association (CLTA) standard policy;
- an American Land Title Association (ALTA) owner's extended coverage policy;
- an ALTA residential (ALTA-R) policy; and
- an ALTA homeowner's policy.

When making an offer, a prospective buyer is informed by his agent about the coverage each type of policy provides. The buyer's need for title coverage must be reviewed when the buyer enters into a purchase agreement since the agreement's title insurance provision calls for the buyer to designate the type of title insurance policy on closing and states who will pay its premium. [See Figure 1]

The buyer's choice of a title policy as selected in the purchase agreement may depend on who is paying the title insurance premium — the buyer or the seller. Customarily, the seller pays the premium, except in some northern California counties.

Whoever will pay the policy premium is disclosed and accounted for in the brokers' disclosures to sellers and buyers of the net proceeds and costs to be expected on closing. [See **first tuesday** Forms 310 and 311]

Unless requested by the escrow holder when ordering a policy under escrow instructions, the tendency of title insurance companies is to issue the more expensive ALTA coverage policies. This condition is permitted by real estate brokers when using purchase agreement forms designed in collaboration with the title insurance industry. Here, the ALTA policy is the **default policy**.

The CLTA standard policy

The California Land Title Association (CLTA) standard policy is purchased solely by buyers, carryback sellers and private lenders, not institutional lenders or builders who generally need extended coverage.

The CLTA standard policy insures against all encumbrances affecting title to the property which can be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an **inspection or survey** of the property, is not covered due to the CLTA policy exclusions and standard exceptions.

Public records include those records which impart *constructive notice* of encumbrances affecting title to the property.

For example, a deed conveying a parcel of real estate which is actually **recorded and indexed** by the county recorder's office imparts constructive notice to buyers and lenders who later acquire an interest in the property. [Calif. Civil Code §1213]

Additionally, the CLTA standard policy (as well as the American Land Title Association (ALTA) policy) protects the insured against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

All title insurance policies provide coverage forever after the date and time the policy is issued, limited in recovery to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the **exclusions, exceptions and conditions on claims**.

The CLTA standard policy (as well as the ALTA policy) contains Schedule A *exclusions to coverage* which bar recovery by the buyer or joint protection carryback seller for losses due to:

- zoning laws, ordinances or regulations restricting or regulating the **occupancy, use or enjoyment** of the land;
- the character, dimensions or location of any **improvement erected** on the property;
- a **change in ownership** or a parceling or combining of the described property by the insured buyer;
- **police power**, eminent domain or violations of environmental protection laws, unless a notice or encumbrance resulting from the violation was recorded with the county recorder before closing;
- encumbrances **known** to the insured buyer or lender which are not recorded or disclosed to the title company;
- encumbrances which do not result in a **monetary loss**;

- encumbrances which are created or become encumbrances **after issuance** of the policy;
- encumbrances resulting from the buyer's payment of **insufficient consideration** for the property or delivery of improper security to the lender also insured under the policy; and
- the unenforceability of the insured trust deed lien due to the lender's **failure to comply** with laws regarding usury, consumer credit protection, truth-in-lending, bankruptcy and insolvency.

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called *standard exceptions* or *regional exceptions*. It is the inclusion of these pre-printed boilerplate exceptions which makes the CLTA policy a standard policy. An ALTA owner's policy does not contain pre-printed exceptions, only the typewritten exceptions listing the encumbrances which are known to the title company and affect title to the property.

The **pre-printed standard exceptions** in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown as existing liens in the records of the county recorder, the county tax collector or any other agency which levies taxes on real property;
- unrecorded rights held by others which the buyer could have discovered by an inspection of the property or inquiry of persons in possession;
- easements or encumbrances which are not recorded and indexed by the county recorder;
- unrecorded encroachments or boundary line disputes which would have been disclosed by a survey; and
- recorded or unrecorded, unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a lower level of risk for indemnified losses due to the CLTA pre-printed exceptions as compared to the extended risks covered by the more expensive ALTA owner's policy.

The ALTA owner's policy and survey

Most policies issued today are of the American Land Title Association (ALTA) variety since the California Land Title Association (CLTA) policy format with pre-printed standard exceptions does not provide protection for **unrecorded encumbrances or claims** to title.

The ALTA owner's policy provides greater coverage (and requires greater premiums) than the CLTA policy since the exceptions in Schedule B do not include the pre-printed standard exceptions. If the pre-printed exceptions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances will not be covered.

The ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy. As a result, the title company may require the parcel to be surveyed, and those in posses-

sion of the property to be interviewed or estopped, before the title company will issue an ALTA policy. Unrecorded interests in title are most often observable by an on-site inspection of the property.

Typewritten exceptions for existing encroachments or boundary conflicts are occasionally added to the ALTA policy (Schedule B) based on the survey.

The exclusions section of an ALTA owner's policy are identical to exclusions in the CLTA policy, except for additional exclusions relating to an insured lender or carryback seller. The ALTA owner's policy is not issued to secured creditors. More precisely, a joint protection ALTA policy is never issued.

Thus, separate policies and duplicate premiums are required for a lender's ALTA coverage when a buyer of property records a new loan.

The premium for an ALTA owner's policy is larger than the premium for a CLTA standard policy. The ALTA owner's policy provides additional coverages and may, as a requisite to issuance, require costs to be incurred for a survey.

Further, the premium is nearly doubled to pay for both a lender's policy and the buyer's policy when a new loan is recorded to fund the purchase of real estate acquired by the buyer. This is not the case for a CLTA joint protection policy covering both the lender and the buyer.

The ALTA residential policy

For buyers of parcels of real estate containing one-to-four residential units, an American Land Title Association Residential (ALTA-R) policy is available in lieu of the ALTA owner's or homeowner's policies. Parcels insured include lots and units in common interest developments (CIDs), such as condominiums.

The ALTA-R is referred to by the title companies as the *"plain language"* policy. The ALTA-R is written using wording which avoids legalese. The policy is structured and written to be easily read and understood by the average buyer. Also, the ALTA-R policy contains a **table of contents** and an **owner's information sheet** which outlines the policy's features.

The coverage, exclusions and exceptions in the ALTA-R policy are similar to the ALTA owner's policy. In addition, the ALTA-R policy covers losses due to:

- mechanic's liens incurred by someone other than the buyer; and
- the inability of the buyer to occupy the property should the single family residence violate the conditions, covenants and restrictions (CC&Rs) listed in the Schedule B exceptions in the policy or existing zoning.

The premium for an ALTA-R policy is priced lower than the premium for an ALTA owner's policy since the ALTA-R policy is usually issued only on parcels in an existing subdivision or CID which has no known problems with easements, encroachments or legal access.

The ALTA homeowner's policy

A **homeowner's policy** now exists to provide **more coverage** than the American Land Title Association (ALTA) owner's or the American Land Title Association Residential (ALTA-R) policies. In addition to the risks covered by the ALTA owner's and ALTA-R policies, the homeowner's policy covers several risks to ownership which could arise **after closing**, including:

- the **forging** of the buyer's signature on a deed in an attempt to sell or encumber the buyer's property;
- the construction on an adjoining parcel of a structure which **encroaches** onto the buyer's property, excluding a boundary wall or fence;
- the recording of a document which prevents the buyer from obtaining a secured loan or selling the property;
- claims of **adverse possession** or **easement by prescription** against the buyer's property; and
- claims by others of a right in the buyer's property arising out of a lease, contract or option **unrecorded and unknown** to the buyer at the time of closing.

The ALTA homeowner's policy also covers losses arising out of a lack of **vehicular and pedestrian access** to and from the property. Other owner's policies only cover losses resulting from the lack of a legal right to access, not a practical means of access which is covered by the ALTA homeowner's policy.

Also covered by the ALTA homeowner's policy are losses incurred due to many other risks which may exist at the time of closing, including:

- the correction of any pre-existing violation of a condition, covenant and restriction (CC&R);
- the inability to obtain a building permit or to sell, lease or use the property as security for a loan due to a pre-existing violation of a subdivision law or regulation;
- the removal or remedy of any existing structure on the property if it was built without obtaining a building permit, excluding a boundary wall or fence;
- damage to existing structures due to the exercise of a right to maintain or use an easement;
- damage to improvements due to mineral or water extraction;
- the enforcement of a discriminatory CC&R;
- the assessment of a supplemental real estate tax due to construction or a change of ownership or use occurring before closing;
- an incorrect property address stated in the policy; and

- the map attached to the policy showing the incorrect location of the property.

Encumbrances relating to the insured title and known to the title company will be itemized in the policy as additional exceptions which limit coverage. The exceptions should be reviewed by the buyer and the buyer's broker in a preliminary title report before closing and issuance of a policy.

The ALTA homeowner's policy contains the same exclusions from coverage stated in the ALTA-R policy, plus an exclusion for any **building code violations**, unless notice of the violation has been recorded with the county recorder (in which case it would be known to the title company and listed as an exception).

Before a ALTA homeowner's policy will be issued by a title insurer, two requirements must be met:

- the property must be *improved* with a one-to-four unit family residence; and
- the buyer must be a natural person, not an entity such as a corporation, limited liability company (LLC) or partnership.

Many title insurance companies use the ALTA homeowner's policy as their "default policy," which they will issue if a specific title policy is not requested by escrow. The premium for the policy is approximately 10% more than the California Land Title Association (CLTA) owner's policy.

Unless the buyer (or seller) calls for a CLTA standard policy, ALTA owner's or ALTA-R policy in the purchase agreement and escrow instructions, the title company will, by the default of the escrow, automatically issue the more expensive policy.

The CLTA standard JP policy

A lender or seller who carries back a note and trust deed for part of the sales price has options when calling for title insurance.

The lender or carryback seller can either:

- be named as an additional insured on a California Land Title Association (CLTA) standard joint protection (JP) title insurance policy with the buyer; or
- request a separate American Land Title Association (ALTA) loan policy as a only named insured.

The JP policy enables one or more individuals or entities to be named as insured.

In addition to the owner's standard CLTA title coverage, the JP policy provides coverage for a trust deed held by a lender or carryback seller. Thus, the JP policy indemnifies the lender or carryback seller against losses arising from risks such as:

- the invalidity or unenforceability of the insured creditor's trust deed lien;

- the priority of a lien or other encumbrance which was not listed in the policy exceptions; and
- the invalidity or unenforceability of an assignment of the insured trust deed when the assignment is listed in the exceptions as affecting the trust deed.

If a loss covered by a JP policy occurs, the named insureds suffering from the loss will share in any recovery up to the dollar limit of the policy, subject to disbursements based on their priority or pro rata interest between themselves in title. Thus, recovery by both the owner and the secured creditor under the JP is not cumulative, nor should it be.

Accordingly, no windfall occurs since title policies only indemnify an insured against the insured's actual monetary loss. If there is no loss of value, there is no basis for recovery.

Most **policy limits** are established based on the value of the property, and as part of that value, the loan amount. Thus, the owner and the lender are fully protected under a JP policy since the aggregate value of their interests (debt and equity) do not exceed the policy limits on closing.

Accordingly, once a policy loss has been paid to an insured owner, lender or carryback seller, the amount of coverage under the policy is reduced.

However, the JP policy is only available under a CLTA standard policy. If either the buyer or lender in a cash-to-new-loan transaction requests ALTA coverage, a separate ALTA loan policy will be issued to each at approximately double the cost.

The ALTA loan policy increases costs

An institutional lender will usually require its trust deed lien on a parcel of real estate to be insured under an American Land Title Association (ALTA) loan policy as a condition for making a loan secured by real estate.

The ALTA loan policy insures against money losses incurred by lenders and carryback sellers due to the loss of priority of the insured trust deed lien, unless listed in the exceptions, to encumbrances such as:

- a mechanic's lien, if the work was commenced prior to recording the trust deed (which is the same date and time as the date of the policy) and the trust deed did not secure a loan to pay for the construction;
- a mechanic's lien arising out of work financed by proceeds from the construction loan secured by the insured trust deed, if no part of the construction work was commenced before the trust deed was recorded; and
- assessments (Mello-Roos) for street improvements under construction or completed prior to recording the trust deed.

However, the ALTA policy does not cover losses resulting from lack of priority of the insured trust deed to a mechanic's lien if:

- the secured loan was not a construction loan designed to finance construction; and
- no part of the construction work which led to the mechanic's lien commenced before the trust deed was recorded.

ALTA **exclusions** in lender policies eliminate coverage for claims arising out of a loan transaction due to the operation of federal bankruptcy law, state insolvency or similar creditors' rights laws, if the claims are based on:

- a *fraudulent conveyance* to the vested owner to conceal assets;
- the *equitable subordination* (a court ordered assignment) of the insured lender's lien; or
- the insured lender's trust deed being deemed a *preferential transfer* by a bankruptcy court due to the recording of the trust deed within 90 days before a bankruptcy filing.

The ALTA loan policy comes at a higher (and separate) premium than the California Land Title Association (CLTA) standard joint protection (JP) policy due to the extended mechanic's lien and assessment coverage, the need to pay premiums on two title policies and the cost of any survey required before issuing a title insurance policy. A buyer who borrows funds to finance his purchase usually pays the premium for the lender's policy.

Who is insured?

Those insured under the California Land Title Association (CLTA) standard policy, American Land Title Association (ALTA) owner's policy or American Land Title Association Residential (ALTA-R) policy, include the name of the insured in **Schedule A** and those **who succeed** to the interest of the named insured by *operation of law*, not by purchase, including:

- heirs;
- distributees;
- devisees;
- joint tenancy or community property survivors;
- personal representatives;
- next of kin by intestate succession; and
- corporate or fiduciary successors.

If title is to be transferred to another vesting, concurrently or within a few months, request should be made the title company to include that vesting as a named insured by endorsement.

However, the ALTA homeowner's policy requires the insured and any covered successor to be **an individual** or the trustee of an inter vivos (living) trust, not an entity such as a Limited Li-

ability Company (LLC). A transfer of title by an insured to their revocable inter vivos trust is covered by the ALTA homeowner's policy without endorsement. This is not the case for other policies.

A policy covering an owner does not cover a buyer who purchases the insured property from the owner. A new policy must be obtained, unless the seller holds a **binder** and uses it to issue a policy in the name of the buyer.

Those insured under a lender's policy of title insurance include:

- the lenders described in the policy;
- future purchasers of the insured trust deed, except assignees who acquire the trust deed as a result of an indemnity, guaranty, other policy of insurance or bond held by the insured lender; and
- any government agency — such as Housing and Urban Development (HUD) and the Veterans Administration (VA) — which insures or guarantees the loan secured by the insured trust deed.

Settling a claim

To begin the claims process, the insured, on becoming aware of an encumbrance covered as a loss by the policy of title insurance, must promptly give the title insurance company written **notice of claim**.

Upon being notified of the claim, the title company has 15 days to:

- acknowledge receipt of the claim or pay the claim;
- provide the insured with all forms, instructions, assistance and information necessary to prove up the claim; and
- begin any investigation of the claim. [10 Calif. Code of Regulations §2695.5(e)(1-3)]

Further, the insured must provide the title company with a *proof-of-loss statement* within 90 days after incurring the loss. The statement must set forth the encumbrance discovered, the amount of the loss, and the basis for calculating the loss. The title company may also require the insured party to make available records, checks, letters, contracts, insurance policies and other papers related to the claim.

After receipt of the 90-day **proof-of-claim statement**, the title insurance company has 40 days to **accept or reject** the claim, in whole or in part. [10 CCR §2695.7(b)]

On accepting a claim as one covered by the policy, the title company may handle the claim in one of several ways, including:

- **pay policy limits**, plus any authorized costs, attorney fees and expenses incurred by the insured;

- **pay the loss** incurred by the insured, plus costs, attorney fees and expenses;
- negotiate a **settlement**;
- bring or defend a **legal action** on the claim; and
- for an insured lender, **purchase the loan** from the lender for the amount owed by the borrower, plus any authorized costs, attorney fees and expenses incurred by the insured lender.

Extent and limitation of liability

The **conditions section** of a title insurance policy limits the amount the title company is required to pay to settle a claim made by an insured owner, tenant or lender.

For owners, the title company can settle a claim by paying the lesser of:

- the full dollar amount of the policy; or
- the reduction in value of the insured's ownership interest caused by the title defect or encumbrance not listed in the policy exceptions which were missed by the title company.

For lenders, the title company can settle a claim by paying the lesser of:

- the full dollar amount of the policy;
- the impairment or reduction in value of the security interest due to the title defect or encumbrance not listed in the policy exceptions; or
- the amounts due on the unpaid loan at the time of the loss caused by a defect or encumbrance not listed in the policy exceptions.

The title company will not pay a claim:

- if the title company is able to remove the encumbrance from title;
- until any litigation over the encumbrance has become final; or
- if the owner or lender settles the claim without written permission of the title company.

Additionally, if the lender is the insured, the title company will not cover additional loan amounts which become secured by the trust deed after the insured trust deed is recorded, called *future advances*.

Future advances made by lenders are covered if the advances are:

- on an insured construction loan;
- to foreclose on a loan;
- to protect title to their lien rights; or

- to preserve the real estate from impairment.

All payments made by the title insurance company to pay claims, except payments made for costs, attorney fees and expenses, reduce the dollar amount of coverage remaining under the title policy.

Chapter 52 — The right of survivorship among co-owners

This chapter distinguishes the joint tenancy and community property with right of survivorship vestings for the co-ownership of real estate, and explains their creation and use as well as severance of the vesting and termination of the right of survivorship.

For a further discussion of this topic, see Chapter 34 of Legal Aspects of Real Estate.

Chapter 52 Outline

Chapter 52 Terms

Affidavit	*Joint tenancy*
Community debts	*Right of survivorship*
Community property	*Separate property*
Intestate	*Testate*

Vesting reflects estate planning

A husband and wife, with the assistance of their broker, locate real estate they intend to purchase. They will use monies accumulated during their marriage and the net proceeds from a new purchase-assist loan to pay the purchase price.

The broker, as part of his due diligence on any property acquisition, asks the couple how they want to take title to the property on the close of escrow. The broker determines the couple would like the property to be vested in both of their names, as husband and wife, with the *right of survivorship*.

On the death of a spouse, the couple wants the surviving spouse to automatically become the sole owner of the property and entirely avoid probate procedures.

The couple is not interested in vesting title under a revocable inter vivos (living) trust agreement which would also avoid probate.

The broker recognizes the community property aspect of their funds as accumulated during the marriage and recommends they take title in their names, such as "husband and wife as community property with **right of survivorship**," rather than "husband and wife as joint tenants." However, the broker explains the two vestings are identical for conveyancing since:

- both vestings can be *severed* before death by either spouse to provide for an alternative distribution of each spouse's ownership interest to others by will, a trust agreement or another vesting of their interest; and
- on death the title is cleared of the deceased spouse's interest by the surviving spouse recording an *affidavit* declaring the death of the decedent and attaching a certificate of death. [Calif. Civil Code §682.1(a); Calif. Probate Code §210; see **first tuesday** Form 461 and Form 460 accompanying this chapter]

Mindful of the **tax consequences** for the surviving spouse, the broker recommends the couple vest title to the property as "community property with right of survivorship." Like the tax consequences of a joint tenancy vesting by spouses, the surviving spouse would be assured a fully **stepped-up cost basis** for the community property.

In this example, the broker's advice to vest the community property as "community property with right of survivorship" satisfies the couple's estate planning needs for holding title to the property located by the broker and purchased by the couple. The property acquisition is made during the marriage, and thus is considered *community property* even if the couple vested the property in their names as joint tenants.

Married couple: wording the grant deed vesting

Joint tenancy: *John Doe and Jane Doe, husband and wife as joint tenants.*

Community property: *John Doe and Jane Doe, husband and wife as community property with right of survivorship.*

Community property: *John Doe and Jane Doe, husband and wife as community property.*

Tenants in common: *John Doe, a married man as to an undivided one-half interest, and Jane Doe, a married woman as to an undivided one-half interest, as tenants in common.*

Separate property of one spouse: *John Doe, a married man as his separate property.*

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

AFFIDAVIT OF DEATH OF JOINT TENANT

Prepared by: Agent ____________________ | Phone ____________________
Broker ____________________ | Email ____________________

DATE: __________, 20____, at ______________________________________, California.

____,

is the deceased named in the attached certified copy of Certificate of Death and the same person named as one of the joint tenants vested as owner of the following property situated in the County of ____________________, California, referred to as:

APN# ____________________

I have personal knowledge of the facts in this affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: __________, 20____ ______________________________________
(Print Name) (Signature)

Date: __________, 20____ ______________________________________
(Print Name) (Signature)

STATE OF CALIFORNIA
COUNTY OF ____________________
SUBSCRIBED and SWORN to (or affirmed) before me on this ____________________ day of __________, 20____,
by ______________________________________,
proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.

____
(Seal)

____
(Signature)

(This area for official notarial seal)

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Additionally, the couple simply intends to avoid probate procedures and administration costs on the death of a spouse. Either right of survivorship vesting avoids enforcement of any contrary provisions in the will of the deceased since no interest remains to be transferred by will or otherwise after death.

Thus, for the surviving spouse, a "**community property** vesting with right of survivorship" is superior to a simple community property vesting — even though a community property vesting (without the right of survivorship) also transfers the property to the surviving spouse if the deceased dies *intestate* (with no will) or *testate* (with a will) stating the surviving spouse takes the property.

On a simple community property vesting, if no one contests the surviving spouse's right to become the sole owner of the deceased spouse's interest in the property, the surviving spouse must wait 40 days following the death before the property can be sold, leased or encumbered.

After 40 days, an **affidavit** by the surviving spouse is recorded to clear title by declaring the death and attaching a death certificate. [Prob C §13540; see **first tuesday** Form 461]

A joint tenancy recommendation by the broker would produce the same results during ownership (transferability) and on death (taxes) as would the community property vesting with right of survivorship. They function identically before and after death. However, joint tenancy allows for avoidance of some *community debts* during the marriage and on death. This avoidance of debts incurred solely by one spouse is not available under either community property vesting. [CC §682.1]

Creating a joint tenancy

Although most *joint tenancies* are created between a husband and wife, a joint tenancy can exist between any non-married persons. Conversely, community property vestings are only available to a husband and wife (or registered domestic partners). [Calif. Family Code §297.5]

Additionally, the number of joint tenants is not limited to two, as is a married couple's ownership of community property interests. Using one deed, any number of co-owners can take title to real estate as joint tenants as long as they take **equal ownership interests** in the property.

Traditionally, the creation of a **joint tenancy** requires the conveyance of **four unities:**

- *unity of title*, meaning the joint tenants take title to the real estate through the **same instrument**, such as a single grant deed;
- *unity of time*, meaning the joint tenants receive their interest in title at the **same time**;
- *unity of interest*, meaning the joint tenants own **equal shares** in the ownership of the property; and
- *unity of possession*, meaning each joint tenant has the **right to possess** the entire property. [**Swartzbaugh** v. **Sampson** (1936) 11 CA2d 451]

Today, a joint tenancy vesting is only loosely based on these four ancient unities. For example, a joint tenancy is currently defined as ownership by two or more persons **in equal shares**. Thus, the joint tenancy co-ownership incorporates the **unity of interest** into its statutory definition. [CC §683]

Similarly, a joint tenancy must be created by a **single transfer** to all the co-owners who are to become joint tenants. Thus, the historic **unity of title** (same deed) and **unity of time** (simultaneous transfers) required under common law have been retained in one event, typically being the recording of the conveyance transferring title to the joint tenants.

A joint tenancy ownership in real estate may be created by any of the following transfers, each being a single conveyance to all joint tenants, if the conveyance states the co-owners take title "as joint tenants":

- a transfer by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate, to himself and others;
- a transfer from co-owners vested as tenants in common to themselves; or
- a transfer from a husband and wife holding title as community property, tenants in common or separately, to themselves. [CC §683]

For the small percentage of joint tenants who are not husband and wife, typically family members or life-long friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their **fractional ownership interest** in the property.

Their actual fraction of ownership, if severed or transferred to others, is a function of the number of individuals who took title as joint tenants. Five co-owners as joint tenants indicate each holds a one-fifth or 20% fractional ownership interest.

A vesting of "community property with right of survivorship" is created on the **acceptance** by a husband and wife of the deed vesting their acquisition of property. For a husband and wife to convert a vesting to community property with the right of survivorship, they merely deed out of their present vesting (as grantors) and deed the property back to themselves in their names as "husband and wife as community property with right of survivorship" (as grantees).

No requirement exists calling for consent to the vesting beyond mere **delivery** of the deed. [CC §682.1(a)]

A joint tenant's right of survivorship

A joint tenancy vesting adds nothing to the legal aspects of the ownership interest held in real estate by each co-owner. Whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest.

However, the **necessary incident** of a joint tenancy vesting is the **right of survivorship**, legally referred to as *jus accrescendi*. The right of survivorship is a case law doctrine which is triggered by the death of one joint tenant.

Thus, the joint tenancy vesting, by the incident of its right of survivorship, becomes operative only on the death of a joint tenant, at which point the right of survivorship **extinguishes the deceased's interest** and leaves the remaining joint tenant(s) with the entire ownership interest they held as joint tenants. The right of survivorship is a mere **expectancy** held by each co-owner, and is not a property right.

Ultimately, and on the death of all other joint tenants, the last survivor becomes the sole owner of the interest in the property originally owned by all the joint tenants.

Vesting alone does not transmute community property

All property acquired jointly by a married couple during the marriage, no matter how vested, is **presumed** to be community property for purposes of division between them on a *dissolution* of the marriage. [Fam C §2581]

Should a couple having vested their co-ownership of property as joint tenants seek a divorce, the property is treated as community property.

Further, the community property presumption for married couples does not only come into play when a couple divorces. All property acquired by a couple or by either spouse during marriage is considered community property, unless the husband and wife clearly state their contrary intention to own their individual interests in the real estate as separate property. [Fam C §760]

Thus, real estate acquired by a married couple, or by a married individual (unless received as a gift), regardless of joint tenancy, community property or inter vivos trust vesting, is always presumed to be community property under California law. [Fam C §761]

The overlay of community property

Joint tenancy rights and community property rights held by married couples **overlap** in California law when community property is placed in a joint tenancy vesting. This overlap is a byproduct of California legal history.

Joint tenancy, with its inherent right of survivorship, arises out of the English common law, and is called a common law estate.

Community property, with its implicit partnership aspect, is a creation of Spanish civil law, dating from the time when California was a Spanish colony operating under the Law of the Indies.

Today, a joint tenancy vesting is used by co-owners solely to avoid probate. The joint tenancy vesting provides no other advantage to co-owners. The underlying community or separate property character of the real estate is not affected when a husband and wife vest their co-ownership as joint tenants.

For example, a husband and wife who take title as joint tenants do not by the vesting **transmute** their community property into separate property owned 50:50 by the husband and wife.

However, a joint tenancy vesting allows a husband and wife, one of whom has a problem with a creditor, to **renounce the community property presumption** and claim they intended the joint tenancy vesting to establish separate property interests for each spouse in the real estate. Thus, the community property presumption can be rebutted by either spouse, and is occasionally exercised by a husband and wife to deter creditors. [**Abbett Electric Corporation** v. **Storek** (1994) 22 CA4th 1460]

A similar result altering community property rights occurs in federal **bankruptcy** proceedings when a husband and wife hold title as joint tenants. The interest of each spouse vested as a joint tenant is treated in bankruptcy proceedings as separate property in order to attain the objective of federal bankruptcy law to free individuals of onerous debt.

Thus, a spouse's one-half interest in community property vested as joint tenants is not liable under bankruptcy for debts which were incurred solely by the other spouse and not on behalf of the community. [**In re Pavich** (1996) 191 BR 838]

If the couple does not intend by the joint tenancy vesting to transmute their community property into separate property, but to take title to their community assets as joint tenants for the sole purpose of avoiding probate (which is the case in most joint tenancy vestings), the property is **presumed** to be a community asset without concern for the joint tenancy vesting.

Thus, the nature of the underlying ownership of property held by a husband and wife as joint tenants — separate or community — may be challenged by a third party, such as a creditor of one of the spouses seeking to reach community assets.

However, title companies will always apply the community property presumption when real estate is vested in a husband and wife. A title company will not insure the conveyance of an interest in the couple's property (such as a trust deed encumbrance) executed by only one spouse, since the signatures of both spouses are required to convey interests or impose liens on community property. [Fam C §1102]

Conveying community property

Both spouses must consent to the sale, lease for more than one year or encumbrance of community real estate regardless of how it is vested. [Fam C §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either ratify the transaction or have it set aside. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to **set aside** the transaction.

However, if the other party to the transaction — the buyer, tenant or lender — has no notice of the marriage, actual or constructive, the transaction cannot be set aside by the nonconsenting spouse who has failed to make the community interest known. This includes any knowledge of the agent representing the buyer, tenant or lender, about the owner's marital status. [Fam C §1102(c)]

Conveying community property as joint tenants

The ability of a married joint tenant to sell, lease or encumber his interest in the real estate depends on whether the real estate interest vested in the individual is his separate property or the community property of the individual's marriage.

When community real estate is vested in joint tenancy, both spouses' signatures are required to execute an enforceable purchase agreement or trust deed lien, or to enter into a lease agreement with a term exceeding one year. [Fam C §1102]

Thus, a sale, long-term lease or encumbrance of the community property executed by only one spouse is **voidable** since the transaction may be set aside by the nonconsenting spouse.

Thus, a purchase agreement entered into by one spouse to sell only his one-half interest in the community property is unenforceable unless consented to by the other spouse since **no interest** in community property may be conveyed, leased or encumbered without the consent of both spouses. [**Andrade Development Company** v. **Martin** (1982) 138 CA3d 330]

Encumbering and leasing joint tenancy property

When real estate held in a joint tenancy vesting is **separate property** — as when the joint tenants are not husband and wife, or when a husband and wife in writing agree their interests are separate property — each joint tenant can sell or encumber his interest in the real estate without the consent of the other joint tenants.

Additionally, when the joint tenancy in real estate represents **separate property**, a joint tenant may lease out the entire property since a lease is a transfer of possession, and each joint tenant has the right to possession of the entire property. [Swartzbaugh, *supra*]

However, consider a husband and wife who own real estate which is **community property**, holding title as joint tenants. The husband enters into an agreement to lease the property for a term over one year, which the wife does not sign.

Under the joint tenancy rule, either joint tenant alone may lease the property. However, under the community property rule (which applies to property acquired during marriage), **both spouses** must execute a long-term lease agreement with a term greater than one year.

This one-spouse leasing scenario is an example of the misunderstanding created by the overlay of community property rights when community property is placed in a joint tenancy vesting.

Although no case or statute addresses this set of leasing facts, existing case law suggests the joint tenancy vesting should be viewed as controlling, thus allowing the joint-tenant husband to lease the property without the wife's consent. Also, the doctrine of ratification would influence the result (in favor of the tenant) if the nonconsenting spouse knowingly enjoyed the benefits of the lease. [CC §2310]

Severing right-of-survivorship vestings

A husband and wife are the owners of a parcel of real estate, as community property. The vesting provides for the right of survivorship under either a community property with right of survivorship vesting or a joint tenancy vesting.

However, every co-owner vested as a joint tenant or as community property with the right of survivorship has the right to *unilaterally sever* the right of survivorship. The severance by a co-owner **terminates** the right of survivorship in that co-owner's interest, whether his interest in the real estate is separate or community property.

The separate or community property nature of the co-owner's interest in the property remains the same after severing the right of survivorship from the co-owner's interest.

A co-owner **unilaterally severing** the right of survivorship in his interest is not required to first give notice or seek consent from the other co-owner(s). [**Riddle** v. **Harmon** (1980) 102 CA3d 524]

To sever the vesting, the co-owner prepares and signs a deed from himself "as a joint tenant" or "as community property with right of survivorship" back to himself. On recording the deed, the right of survivorship is severed by having merely revested the co-owner's interest. The deed revesting title should include a statement noting that the transfer is intended to sever the prior vesting. [CC §683.2(a)]

Recording requirement for severance

Recording is necessary to terminate another joint tenant's right of survivorship. The **unilateral severance** (deed) of a joint tenant's interest must either be:

- recorded in the county where the property is located before the death of the severing joint tenant; or
- recorded within seven days after the joint tenant's death if executed and notarized within three days before the joint tenant's death. [CC §683.2(c)]

Additionally, the joint tenancy may be severed by agreement of the joint tenants. If a written agreement to sever the joint tenancy is signed by all the joint tenants, recording or notarization is not required. [CC §683.2(d)]

All the preceding rules for recording a severance deed apply fully to the severance deed of a spouse seeking to terminate the right of survivorship held under the community property vesting. [CC §682.1]

The unilateral severance of a joint tenancy terminates the right of survivorship. Without the existence of the right of survivorship, each co-owner disposes of his interest in the property on death as he wishes, such as by will or inter vivos trust, or by the severance itself.

Although the sale of a joint tenant's separate property interest in real estate severs the joint tenancy, a lease or encumbrance of the property by a joint tenant does not.

All the procedures for severing a joint tenancy are fully available for a husband or wife to sever the community property vesting which includes the right of survivorship. [CC §682.1]

Clear title on death by affidavit

When co-ownership of property is vested as a joint tenancy, the death of a joint tenant *automatically extinguishes* the deceased joint tenant's interest in the real estate, leaving the surviving joint tenant(s) as the sole owner(s). However, the deceased joint tenant's interest in the property must be cleared from the title before the surviving joint tenant(s) will be able to sell, lease or encumber the property as the sole owner.

The new ownership interest of the surviving joint tenant(s) is documented by simply recording an **affidavit**, signed by anyone, declaring the death of a joint tenant who was a co-owner of the described real estate. [Prob C §210(a)]

The interest in the property held by the deceased spouse "as community property with right of survivorship" is extinguished by the same **affidavit** procedure used to eliminate the interest of a joint tenant, except the surviving spouse (or his representative) is the only one authorized to make the declaration. [See **first tuesday** Form 461]

The *joint tenancy affidavit*, which is a statement made under the penalty of perjury, includes:

- the name of the deceased joint tenant, sometimes called the **decedent**;
- a copy of the deceased joint tenant's death certificate;
- a description of the real estate affected by the joint tenant's death; and
- a statement the deceased is the person vested in title to the described property as a joint tenant. [See Form 460]

Once the affidavit is **notarized, recorded and indexed**, anyone conducting a title search on the property will have notice of the joint tenant's death since the deceased joint tenant is indexed as a grantor. Thus, the surviving joint tenant becomes the **sole owner** of the property due to the right of survivorship.

Controlling the vesting of one-half

A spouse can unilaterally sever the joint tenancy and community property with right of survivorship vestings by:

- executing and delivering a deed that conveys legal title to a third party;
- executing a deed to him or herself;
- executing a written severance of joint tenancy; or
- executing a written instrument that evidences an intent to sever. [CC §683.2(a)]

Additionally, the community property interest of a spouse who executes a deed to him or herself to sever the title and eliminate the right of survivorship remains community property.

Community property cannot be transmuted to separate property without the consent of both spouses or a court order.

A **severance deed** to oneself terminating the right of survivorship is not sufficient by itself to avoid passing the property to the surviving spouse on death for community property vested as either community property with right of survivorship or in joint tenancy.

A will must also be prepared or a living trust established (and vested with title to the property) naming the person intended to receive the spouse's community property interest on death.

Otherwise, since it is community property, the property will pass by intestate succession (without a will) to the surviving spouse as though the severance of the vesting had never occurred. [Prob C §13500]

Joint tenancy tax aspects

Taxwise, the main question raised for a husband and wife when the surviving spouse becomes the sole owner of what was community property, no matter how it was vested by them, is: What is the surviving spouse's **cost basis** in the property as the sole owner after the death of the other spouse?

The surviving spouse who becomes the sole owner of community real estate on the death of the other spouse receives a fully stepped-up cost basis to the property's **fair market value** (FMV) on the date of the death which terminated the community property vesting.

Thus, the surviving spouse is entitled to a fully **stepped-up cost basis** in the real estate previously owned by the community without concern for whether the property was vested as community property (with or without the right of survivorship), as joint tenants or in a revocable inter vivos (living) trust.

State law controls how marital property will be characterized for federal tax purposes. Federal law is unconcerned with the form in which title is taken to community property. [IRS Revenue Ruling 87-98]

Under California law, all property acquired by a husband and wife during marriage is community property, regardless of the vesting, if it is acquired, managed and operated as a community asset by the couple. [Fam C §760]

Thus, the real estate owned by a husband and wife (unless vested as tenants in common) is considered community property for federal income tax purposes. Accordingly, a surviving spouse entitled to the property receives a fully stepped-up cost basis to the property's FMV on the date of the other spouse's death.

Chapter 53 The lis pendens in litigation

This chapter explains the use of a lis pendens and the requisite of a probably-valid claim to record a lis pendens.

For a further discussion of this topic, see Chapter 42 of Legal Aspects of Real Estate.

Chapter 53 Outline

Clouding the title with a notice
Preservation of title
Title or possession to real estate
Improper use of a lis pendens
The lis pendens process
Notice by recording and indexing
Title insurers and specific performance actions
Expungement of a lis pendens

Chapter 53 Terms

Absolutely privileged publication	*Lis pendens*
Expungement	*Notice of Pending Action*
Indexing	*Recording*

Clouding the title with a notice

Lis pendens is the latin phrase for *pending litigation*. More commonly, a lis pendens is referred to as a **Notice of Pending Action**. In this example, the pending action noticed by the recorded lis pendens is the buyer's filing of a lawsuit for the specific performance of the original purchase agreement entered into with the seller.

Persons who acquire an ownership interest, a lien or take possession to real estate after a lis pendens describing the property has been recorded, take their interest in the property subject to the claimant's right, if any, to the real estate.

Preservation of title

The purpose of recording a **lis pendens** is to preserve a person's rights to the real estate until the dispute with the owner is resolved.

Without a recorded lis pendens or physical possession of the real estate, the person who claims an interest in title or the right to possession of the real estate, such as the buyer in our prior example, runs the risk the owner will encumber or convey the property to another buyer, lender or tenant who is unaware someone else already holds an interest in the property.

Occasionally another buyer or a lender acquires possession or a lien on the real estate before they become aware or are on notice of a dispute between the property owner and someone else (claimant) over title or possession. Then, the claimant in the dispute loses his rights to recover that interest, to the extent the interest he was to receive was conveyed to that someone else.

Title or possession to real estate

A lawsuit must affect title or the right to possession of real estate to support the recording of a lis pendens. [Calif. Code of Civil Procedure §405.20]

Lawsuits affecting title or possession of real estate include:

- specific performance of unclosed transactions or rescission of closed transactions [**Wilkins** v. **Oken** (1958) 157 CA2d 603];
- judicial foreclosure of a trust deed lien by a lender [**Bolton** v. **Logan** (1938) 30 CA2d 30];
- foreclosure of a mechanic's lien by a construction contractor [Calif. Civil Code §3146];
- cancellation of a grant deed or other conveyance by a prior owner;
- fraudulent conveyance to be set aside as voidable by creditors [**Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67];
- evictions and suits concerning unexpired leaseholds brought by tenants or leasehold lenders;
- termination or establishment of an easement between neighboring property owners [**Kendall-Brief Company** v. **Superior Court of Orange County** (1976) 60 CA3d 462];
- government declaration that a building is uninhabitable;
- ejectment of an unlawful occupant (other than a tenant) from real estate by an owner;
- partition or sale of the real estate by a co-owner;
- quiet title;
- eminent domain actions [CCP §1250.150]; and
- divorce proceedings involving real estate.

The recording of a lis pendens is also **permitted** in the following lawsuits over real estate:

- actions by adverse possessors to determine claims to title [CC §1007];
- actions to re-establish lost land records [CCP §751.13];
- actions to determine adverse interests in any liens or clouds on real estate arising out of public improvement assessments [CCP §801.5];

- actions by purchasers or the state to quiet title to tax-deeded property [Calif. Revenue and Taxation Code §3956];
- actions by innocent improvers of real estate against owners or lenders of record [CC §1013.5(b)];
- actions on an improvement bond [Calif. Streets and Highways Code §6619]; and
- actions terminating or establishing an easement, except for a public utility easement. [CCP §405.4(b)]

Improper use of a lis pendens

Actions in which it is **improper** to record a lis pendens include:

- suits affecting title to *personal property* located on real estate;
- foreclosure on real estate by a trustee's sale;
- actions to impress a trust on personal property being recovered;
- actions to recover attorney fees;
- actions for breach of a real estate contract when only money losses are sought;
- actions for recovery of a brokerage fee on the sale or lease of property; and
- actions against a partner, member or stockholder co-owning real estate as a partnership, limited liability company (LLC) or a corporation.

The lis pendens process

To record a lis pendens, a lawsuit must first be filed involving *title or possession* of the real estate. [CCP §405.20]

The lis pendens must:

- identify the parties to the lawsuit; and
- give an adequate description of the real estate. [CCP §405.20]

While the object of the lawsuit and its affect on title or possession of real estate does not need to be stated in the lis pendens, the **objective** of the lawsuit must be stated in the lis pendens for it to be considered an *absolutely privileged publication*. [CC §47(b)(4)]

*Editor's note — An **absolute privilege** covers any publication during a judicial proceeding which is authorized by law, including a lis pendens. A publication made under absolute privilege bars a **slander of title** action against the person wrongfully claiming an interest in the property.*

A technical legal description of the property subject to litigation is not required as long as the property can be sufficiently identified.

Notice by recording and indexing

A lis pendens is properly of record when it is *filed and indexed* in the county recorder's office of the county where the property is located. The lawsuit it references must involve a claim to a *right to title or possession* of the real estate described in the lis pendens. [CCP §405.20]

Recording and **indexing** a lis pendens is constructive notice to all persons about the existence of a dispute over title or possession of a property. Any buyer, lender or tenant who is later conveyed an interest in the property will be bound by the final resolution of the dispute.

Title insurers and specific performance actions

Title companies usually refuse to insure title when a lis pendens is recorded against title which involves a specific performance action. Without title insurance, buyers will not buy, lenders will not lend and tenants will not occupy the property.

However, a lis pendens in a buyer's specific performance action does not interfere with a title company insuring a lender's trust deed which secures a debt in an amount less than the price the buyer will be paying for the property. [**Behniwal** v. **Mix** (2007) 147 CA4th 621]

As a result, property subject to specific performance actions by buyers is often rendered unmarketable while the lis pendens remains in effect.

The tremendous value of the lis pendens to litigating buyers is its ability to preserve the buyer's right to purchase the property. The recording of a lis pendens often persuades a hedging seller to perform.

Accordingly, the **potential for abuse** of the lis pendens procedure to cloud title of an owner's property is readily apparent.

Further aggravating to hostile owners is the rule that a recorded lis pendens identifying a court action which actually concerns title or right of possession to real estate is an absolutely privileged communication. [CC §47(b)(4)]

A publication made under an absolute privilege bars the owner from initiating a *slander of title* action against the person who claims to hold an unrecorded interest in the property.

Expungement of a lis pendens

Any time after a lis pendens has been recorded, anyone with an interest in the property affected may file a motion asking the court to remove the lis pendens from the record, called *expungement*.

An order **expunging** a lis pendens removes from title any restrictions sought to be imposed by the lawsuit on the transfer of the property described in the lis pendens. [CCP §405.61]

Once a lis pendens has been successfully expunged, another lis pendens may not be recorded against the property by the same person without the permission of the court. [CCP §405.36]

If the owner, or any other person with an interest in the property, contests a lis pendens which clouds title to his property, the person filing the lis pendens has to prove:

- the action affects title or the right of possession to the property described in the notice; and
- a valid claim exists on which he will **probably prevail** at trial. [Hunting World, Incorporated, *supra*]

If these two requirements are not established, the lis pendens will be ordered expunged and will no longer affect title.

Chapter 54 — Automatic and declared homesteads

This chapter distinguishes the home-equity protection available to a homeowner against creditors under a recorded declaration of homestead and an automatic homestead.

For a further discussion of this topic, see Chapter 44 of Legal Aspects of Real Estate.

Chapter 54 Outline

The owner's homestead interest in title
Automatic and declared homesteads
Real estate to be homesteaded
Amount of equity protected
Forced sale by court order only
Automatic homestead as a shield
Declared homestead allows resale
Clearing title of a lien

Chapter 54 Terms

Automatic homestead	*Involuntary lien*
Declaration of homestead	*Voluntary lien*

The owner's homestead interest in title

A *homestead* is the dollar amount of the equity in a homeowner's dwelling that the homeowner qualifies to hold. The amount of the homestead held by the homeowner has priority on title over most judgment liens and some government liens.

Two types of **homestead** procedures are available to California homeowners to establish the priority of the homestead equity they hold in their home:

- the *declaration of homestead*, which is recorded [Calif. Code of Civil Procedure §704.920]; and
- the *automatic homestead*, also called a *statutory homestead exemption*, which is not recorded. [CCP §704.720]

Both homestead arrangements provide the same dollar amount of home-equity protection given to all homeowners in California.

However, a homeowner must record a **declaration of homestead** to receive the additional benefits available under the homestead laws allowing the homeowner the right to sell and to reinvest the dollar amount of the homestead in another home.

Declaring a homestead as asset preservation

The **recorded homestead declaration** includes:

- the name of the homeowner declaring the homestead;
- a description of the property homesteaded; and
- a statement that the declared homestead is the principal dwelling in which the homeowner resides on the date the homestead is recorded. [Calif. Code of Civil Procedure §704.930(a); see Form 465 accompanying this chapter]

The declaration must be signed, notarized, and recorded to take effect. [CCP §704.930]

The homestead declaration may be **signed and recorded** by any one of several individuals, including:

- the owner of the homestead;
- the owner's spouse; or
- the guardian, conservator, attorney in fact, or a person otherwise authorized to act for the owner or the owner's spouse. [CCP §704.930(b)]

An individual's personal residence that is vested as a revocable inter vivos (living) trust, or other type of title holding arrangement established for the benefit of the homeowner, can also be declared a homestead by anyone who has an interest in the property and resides there. [**Fisch, Spiegler, Ginsburg & Ladner** v. **Appel** (1992) 10 CA4th 1810]

Additionally, a declaration of homestead in no way restricts the homeowner's ability to voluntarily sell, convey, or encumber his homesteaded property. [CCP §704.940]

A recorded homestead declaration does not appear in credit reports or impact the homeowner's credit reputation or ability to borrow funds. Title companies disregard recorded homestead declarations, except in litigation guarantee policies.

Neither the declared nor the automatic homestead interfere with:

- *voluntary liens* later placed on the property by the homeowner, such as trust deeds; and
- *involuntary liens* given priority to the homestead exemption under public policy legislation.

Involuntary liens and encumbrances that are given priority by statute and can be enforced as senior to the amount of the homestead exemption include mechanic's (contractor's) and vendor's (seller's) liens, homeowners' association (HOA) assessments, judgments for alimony or child support, real estate taxes, and Internal Revenue Service (IRS) liens.

Involuntary liens that are subordinate and junior to the homestead amount include:

- Franchise Tax Board (FTB) personal income tax liens;
- Medi-Cal liens; and
- judgment creditor's liens.

Automatic and declared homesteads

An **automatic homestead** is always available on the principal dwelling occupied by the homeowner or his spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy by the homeowner continues until a court determines the dwelling is a homestead. [CCP §704.710(c)]

The **automatic homestead exemption** applies to the equity in a real estate dwelling (and its outbuildings), a mobilehome, a condominium, a planned development, a stock cooperative, or a community apartment project together with the land they rest on, as well as a houseboat or other waterborne vessel used as a dwelling. [CCP §704.710(a)]

On the other hand, a **recorded declaration of homestead** applies only to real estate dwellings. Thus, mobilehomes not established as real estate and houseboats are not protected by a recorded homestead, only the automatic homestead. Also, a leasehold interest in real estate with an unexpired term of less than two years is not protected by a recorded homestead declaration. [CCP §704.910(c)]

Real estate to be homesteaded

As long as the homeowner claiming the exemption actually uses the homesteaded property as the principal residence for himself and his family, the type of real estate qualifying for a homestead includes:

- two five-room flats [**Viotti** v. **Giomi** (1964) 230 CA2d 730];
- an 18-unit apartment building where the owner occupies only one unit [**Phelps** v. **Loop** (1944) 64 CA2d 332]; and
- 523 acres of rural land with a house and water rights for the land. [**Payne** v. **Cummings** (1905) 146 C 426]

Amount of equity protected

The dollar amount of whichever home equity protection a homeowner qualifies for is protected whether the homeowner relies on the automatic homestead or records a declaration of homestead.

Homeowners qualify for one of three dollar amounts of **net equity** homestead protection:

- a $75,000 equity for a homeowner with no dependents;
- a $100,000 equity for a head of household; or
- a $175,000 equity for the aged or disabled. [CCP §704.730]

An individual homeowner with **no dependents** other than himself qualifies for the $75,000 homestead exemption. [CCP §704.730(a)(1)]

A homeowner qualifies for the $100,000 homestead exemption as the **head of a household** by providing support for a spouse, dependent children, grandchildren, parents, grandparents, or in-laws. [CCP §704.730(a)(2)]

An aged or disabled homeowner qualifies for the $175,000 homestead exemption if the homeowner or his spouse is:

- 65 or older;
- physically or mentally disabled; or
- 55 or older with an annual income of less than $15,000 or, if married, a combined gross annual income of no more than $20,000. [CCP §704.730(a)(3)]

Both a husband and a wife may be the declared homestead owners in the same homestead declaration when both husband and wife own an interest in the property. [CCP §704.930(a)(1)]

However, a couple's combined homestead exemption cannot exceed the exemption limit for a head of household ($100,000), unless one or both qualify as an aged or disabled person ($175,000). [CCP §704.730(b)]

Further, if both spouses are entitled to a homestead exemption, the homestead proceeds will be apportioned to each spouse according to their share of the ownership in the homesteaded real estate. [CCP §704.730(b)]

Forced sale by court order only

The sale of a homesteaded dwelling can be forced by a creditor if a net equity exists beyond the amount of the homestead the home owner holds in the property. To force the sale of a homeowner's dwelling, the creditor must first **file an application** for a judicially ordered sale, called an *execution sale*, stating under oath:

- a description of the property;
- whether a declared homestead has been recorded on the property;
- the names of the person or persons who claim the homestead;
- the amount of the homestead; and

- the dollar amounts of all liens and encumbrances recorded on the property and the names and addresses of the lienholders. [CCP §704.760]

If the homestead is declared and the creditor challenges the **validity of the declaration**, the creditor must prove the property does not qualify for a homestead.

However, if the homeowner has not recorded a declaration of homestead on the property, the homeowner must prove his residency in the dwelling qualifies the property for the automatic homestead exemption. [CCP §704.780(a)(1)]

If the execution sale of the property is ordered by the court and the bids received at the sale are insufficient to satisfy the senior liens and encumbrances, plus the homestead amount and the sales costs, the dwelling will not be ordered sold. [CCP §704.800(a)]

Additionally, a winning bid must exceed **90%** of the fair market value (FMV) of the property as set by the court. [CCP §704.800(b)]

A real estate appraiser is often appointed by the court as a *reference* to assist in determining the FMV of the dwelling. Compensation for the appraiser may not exceed comparable fees for similar services in the community. [CCP §704.780(d)]

If the dwelling is jointly owned by the judgment debtor/homeowner and another person as joint tenants or tenants in common, only the judgment debtor's interest in the property will be sold. [CCP §704.820(a)]

The proceeds from an execution sale of the dwelling are disbursed in the following order:

- pay all senior liens and encumbrances on the property;
- disburse the amount of the homestead equity to the homeowner;
- cover the costs of the sale;
- pay the judgment creditor's court costs; and
- pay the amount due to the creditor from the judgment. [CCP §704.850]

Any remaining proceeds from an execution sale go to the homeowner.

Automatic homestead as a shield

An **automatic homestead** exempts some or all of the equity in a homeowner's dwelling up to the dollar amount of the homestead exemption from money judgments obtained by the homeowner's creditors. However, use of the automatic homestead is limited to providing a **shield**, raised by the homeowner, to defend the equity in his house against a forced sale sought by an involuntary creditor.

For example, a homeowner claims his automatic exemption and receives funds in the amount of the homestead equity from a creditor's forced sale of his home. The homestead funds are

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street
Address

City &
State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DECLARATION OF HOMESTEAD

Prepared by: Agent ____________________________ **Phone** ______________________
Broker ____________________________ **Email** ______________________

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

1. The name of the owner or owners of the real estate subject to this declared homestead

____

(Enter the name of the individual entitled to the Homestead Exemption)

2. The declared homestead regards real estate situated in the City of ___________________________________, County of ___________________________________, California, referred to as:

2.1 The property is more commonly referred to as

____.

(Enter the street address and the city)

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— — — PAGE TWO OF TWO — FORM 465 — — —

3. The declared homestead is the principal dwelling and is now resided in as the residence of:
- ☐ A declared owner of the homestead;
- ☐ The declared owners of the homestead; or
- ☐ The spouse of the declared owner of the homestead.

4. I execute this declaration of homestead as:
- ☐ a declared homestead owner.
- ☐ the spouse of the declared homestead owner.
- ☐ the guardian or conservator of the person or estate of the:
  - ☐ declared homestead owner; or
  - ☐ spouse of the declared homestead owner.
- ☐ an attorney in fact for the:
  - ☐ declared homestead owner; or
  - ☐ spouse of the declared homestead owner.

4.1 As a guardian, conservator or attorney in fact acting on behalf of the declared homestead owner or the spouse of the declared homestead owner, I am authorized to execute this declaration under the authority vested in me by ______________________________.
(Enter identification of the source of your authority)

5. The facts stated above are known to me to be true as of my own personal knowledge.

Date: ____________, 20_____ ______________________________
(Print name) (Signature)

Date: ____________, 20_____ ______________________________
(Print name) (Signature)

STATE OF CALIFORNIA
COUNTY OF______________________
On ______________________ before me,
____
(Name and title of officer)
personally appeared ______________________
______________________,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.
I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.
WITNESS my hand and official seal.
Signature: ______________________
(Signature of notary public)

(This area for official notarial seal)

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protected from the creditor's attachment during a six-month reinvestment period. Further, an automatic homestead exemption is provided on the replacement residence to protect the reinvested funds. [CCP §704.720(b)]

Editor's note — Although the proceeds are protected from attachment by the creditor's lien for the six-month reinvestment period, if the property purchased is in the same county where the lien is recorded, it will not prevent the lien from attaching to new property (subject to the homestead exemption) the instant title is transferred into the buyer's name.

Thus, a homeowner/debtor intending to purchase a replacement home in the same county with his protected funds will probably not be able to obtain title insurance for a new loan. Title com-

panies will not make a determination as to whether an exemption on the residence is valid. Also, the abstract lien will attach to the property as a lien senior in time to the new lender's trust deed, unless it is a trust deed carried back by a seller.

The best way to deal with the intervening (judgment) lien in counties where the abstract of judgment is recorded is to purchase property either subject to an existing trust deed or by creating a carryback trust deed. Carryback trust deeds have priority over any lien attaching to the title when the buyer takes title. [Calif. Civil Code §2898]

With the automatic homestead exemption, a homeowner who **voluntarily sells** his residence while title is clouded by a creditor's lien leaves the sales proceeds unprotected by the automatic exemption.

This is not the case for a sale subject to a recorded declaration of homestead. The declaration with priority allows the homeowner to first withdraw his homestead amount from the sales proceeds before the judgment creditor receives any funds.

Declared homestead allows resale

A recorded declaration of homestead, in contrast to an automatic homestead exemption, allows a California homeowner to take the offensive against his creditors. Used as a sword, the declaration of homestead coupled with a quiet title action allows the homeowner to **sever the liens** attached to his title.

Unlike the automatic homestead exemption, judgment liens **do not attach** to the exempt homestead amount in the equity under a declared homestead if the homestead declaration is recorded prior to the recording of the creditor's abstract of judgment. [CCP §704.950(a)]

Judgment liens do, however, attach to any equity exceeding the amount of the declared homestead exemption and all liens and encumbrances on the property at the time the abstract of judgment is recorded. [CCP §704.950(c)]

With prior planning, priority of the declaration over judgment creditors can be accomplished by the homeowner. While it takes the creditor several months to obtain and record an abstract of judgment, a declaration of homestead can be prepared and recorded on readily available forms in a matter of minutes. [See Form 465]

Once recorded, a declaration of homestead lasts until:

- the homestead owner records a declaration of **abandonment of the homestead**; or
- the homestead owner records a **new declaration** of homestead on another residence. [CCP §§704.980, 704.990]

If a homeowner wishes to **sell his declared homestead** that has become clouded with a creditor's lien, the homeowner may either:

- negotiate a release of the lien with the creditor; or

- clear title to the home through a quiet title action based on the priority of his declaration of homestead.

Clearing title of a lien

A *quiet title* action determines the priorities of the creditor's lien and the recorded homestead on title. If the homeowner demonstrates the homestead declaration is valid and was recorded prior to the creditor's lien, the title will be cleared of the lien, provided no equity remains in the property above the homestead amount. [Viotti, *supra*]

Judgment creditors junior to a declared homestead where no excess equity exists soon realize their futility in litigation. Thus, they are generally receptive to a negotiated release. Consequently, the homeowner can usually "buy" a partial (or full) release from the creditor — typically for less than the costs of a **quiet title** action. [See **first tuesday** Form 409]

After title is cleared and the homeowner sells his property, he has six months to reinvest the homestead proceeds in another home. If the proceeds are reinvested in a new residence within six months, the new residence may then be declared a homestead by recording a homestead declaration within six months after the purchase.

When the homeowner records a new homestead declaration on his replacement residence, the recording *relates back* to the time the prior homestead was recorded. This leaves no gap for the creditor's lien to gain priority over the homestead declaration on the new residence. [CCP §704.960]

If the homestead equity exemption has increased after the creditor recorded his abstract of judgment, the amount of exemption the property owner is entitled to in his **new residence** is the amount that was in effect when the abstract of judgment was recorded, not the current increased amount.

However, if the homeowner has not invested the proceeds of the sale in a new homestead after six months, and the proceeds are still in the State of California, the proceeds of the homestead sale can be attached by the judgment creditor.

An alternative to vesting title in the judgment debtor's name is to use a title holding arrangement, such as a corporation or limited liability company (LLC) created by the homeowner to hold title. Thus, the abstract of judgment against the homeowner will not automatically attach to the title held by these entities.

Notes and Their Provisions

Chapter 55 The promissory note

This chapter reviews the types of notes used to evidence debt in financing arrangements which are secured by real estate.

For a further discussion of this topic, see Chapter 4 of Real Estate Finance.

Chapter 55 Outline

Evidence of the debt
The promissory note
Installment note, interest included
Installment note, interest extra
Straight notes
Payment variations
Financial aspects
Interest rate limitations on loans
The trust deed
Satisfaction of the debt

Chapter 55 Terms

Adjustable rate mortgage (ARM)	*Payor*
Contingent interest	*Reconveyance*
Creditor	*Shared appreciation mortgage*
Debtor	*Signature loan*
Fixed rate mortgage (FRM)	*Trust deed*
Graduated payment	*Usury*

Evidence of the debt

Almost all real estate sales hinge on the **financing** of some portion of the purchase price. The buyer promises to pay a sum of money, in installments or a single payment at a future time, either to the seller of the real estate or a lender who funds the sales transaction.

Given in exchange for property or a loan of money, the promise to pay evidences a debt owed by the borrower and payable to the seller or lender to whom the promise is made.

Usually, the promise to pay is set out in a written document called a promissory note, signed by the buyer/borrower. A promissory note merely represents an underlying debt owed by one person to another.

The signed promissory note is not the debt itself, but **evidence** the debt exists.

The borrower, called the *debtor* or *payor*, signs the note and delivers it to the lender or carryback seller, also called the *creditor*.

The note can be either unsecured or secured. If the note is secured by real estate, the security device which should always be used is a trust deed. When secured, the debt becomes a voluntary lien on the borrower's real estate or the property purchased, as described in the trust deed.

The promissory note

Notes are categorized by the method for repayment of the debt:

- installment notes; and
- straight notes.

The installment note is used for debt obligations with constant periodic repayments in any amount and frequency negotiated.

Variations of the installment note include:

- interest-included; and
- interest-extra.

Finally, notes are further distinguished based on interest rate calculations:

- fixed interest rate notes, commonly called *fixed rate mortgages* (FRMs); and
- variable interest rate notes, commonly called *adjustable rate mortgages* (ARMs).

Installment note, interest included

An interest-included installment note with constant periodic payments produces a schedule of payments containing diametrically varying amounts of principal and interest from payment to payment. Principal reduction (on the loan) increases and interest paid decreases with each payment. [See Form 420 accompanying this chapter]

Each payment is applied first to the interest accrued and owing on the remaining principal balance through the end of the payment period, typically monthly. The remainder of the payment is then applied to reduce the principal balance of the debt.

Interest-included installment notes may either:

- be fully amortized through constant periodic payments until paid; or
- include a final/balloon payment after a period of installment payments, called a due date.

NOTE SECURED BY DEED OF TRUST

Installment — Interest Included

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

$____________, dated ____________, 20____, at ________________________________, California.

1. In installments, for value received, I, jointly and severally, promise to pay to
   1.1 ____, as the Payee, or order,
   1.2 at ____,
   1.3 the sum of ____ DOLLARS,
   1.4 with interest from ____________, 20____, on unpaid principal,
   1.5 at the rate of ______% per annum.
2. Principal and interest payable in installments of ____________________ DOLLARS, or more,
   2.1 on the ____________ day of every ☐ month ☐ quarter ☐ year,
   2.2 beginning on the ____________ day of ____________, 20____,
   2.3 and continuing until ____________, 20____, when the principal is due and payable.
   2.4 Principal and interest payable in lawful money of the United States.
   2.5 Each payment shall be credited first on interest then due and the remainder on principal.
3. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.
4. ____
5. In any action to enforce this Note, the prevailing party shall receive attorney fees.
6. This Note is secured by a DEED OF TRUST.

Payor's Name: ____________________	Payor's Name: ____________________
Signature: ____________________	Signature: ____________________
Payor's Name: ____________________	Payor's Name: ____________________
Signature: ____________________	Signature: ____________________

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Installment note, interest extra

Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid concurrently with the principal installment.

The principal payments typically remain constant, from payment to payment, until the principal amount is fully paid or a due date occurs. Accordingly, the interest payment decreases with each payment of principal since the interest is paid on the remaining balance. [See **first tuesday** Form 422]

Thus, unlike an interest-included note, the amount of each scheduled payment of principal and interest on an interest-extra note is not constant from payment to payment.

Straight notes

A *straight note* calls for the entire amount of its principal to be paid in a single lump sum due at the end of a period of time, perhaps five years after close of escrow or on a fixed future date. No periodic payments of principal are scheduled, as in the installment note. [See **first tuesday** Form 423]

Interest usually accrues unpaid and is due with the lump sum principal installment, financing sometimes referred to as a "sleeper" trust deed. Occasionally, the interest accruing is paid periodically during the term of the **straight note**, such as monthly payments of interest only with the principal all due in seven years.

The straight note is typically used by bankers for short-term loans, called a *signature loan*, since a banker's short-term note is not usually secured by real estate.

Payment variations

While the installment note and the straight note are common, variations on the interest rate and repayment schedules contained in the installment and straight notes are available to meet the specific needs of the lender and borrower. The variations include the:

- adjustable rate note (ARM);
- graduated payment note (GPM);
- all-inclusive note (AITD); and
- shared appreciation mortgage (SAM).

The **adjustable rate note** (ARM), as opposed to a fixed-rate note, calls for periodic adjustments to both the interest rate and the amount of scheduled payments. The interest rate will vary according to a particular index, such as adjustments every six months based on the cost-of-funds index for the 11th District Federal Home Loan Bank.

NOTE SECURED BY DEED OF TRUST

Installment Note — Interest Extra

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

$____________, dated ____________, 20_____, at ______________________________, California.

1. In installments as herein stated, for value received, I/we, jointly and severally, promise to pay to
   1.1 ______________________________, as the Payee, or order,
   1.2 at ______________________________,
   1.3 the sum of ______________________________ DOLLARS,
   1.4 with interest from ____________, 20_____, on unpaid principal,
   1.5 at the rate of _____% per annum.
2. Interest payable on the ____________ day of every ☐ month ☐ quarter ☐ year,
   2.1 beginning on the ____________ day of ____________, 20_____.
3. Principal payable in installments of ______________________________ DOLLARS, or more,
   3.1 on the ____________ day of each ____________ month,
   3.2 beginning on the ____________ day of ____________, 20_____,
   3.3 and continuing until ____________, 20_____, when the principal is due and payable.
4. Principal and interest payable in lawful money of the United States.
5. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.
6. ______________________________
7. In any action to enforce this Note the prevailing party shall receive attorney fees.
8. This Note is secured by a DEED OF TRUST.
9. ☐ See attached Signature Page Addendum. [ft Form 251]

Payor's Name: ____________________ Payor's Name: ____________________

Signature: ____________________ Signature: ____________________

Payor's Name: ____________________ Payor's Name: ____________________

Signature: ____________________ Signature: ____________________

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The ARM provides the lender with periodic increases in his yield on the principal balance during periods of rising and high short-term interest rates.

When an upward interest adjustment occurs, the note's repayment schedule should call for an increase in the monthly payment to maintain the original amortization period. If the amount of the original monthly payment is retained without an increase compared to an increase in the interest rate, a longer or negative amortization results.

Graduated payment (GPM) provisions are in greater demand when interest rates or home prices rise too quickly. Fewer buyers are able to currently meet increased cost of financing home ownership.

A graduated payment schedule allows buyers time to adjust their income and expenses in the future to begin the eventual amortization of the loan. Often a GPM has a variable interest rate, called a *GPARM loan*.

For example, the GPM provision allows low monthly payments on origination. The payments are gradually increased over the first three- to five-year period of the loan, until the payment amortizes the loan over the desired number of remaining years.

However, any accrued monthly interest remaining unpaid each month is added to the principal balance on the carryback note, called *negative amortization*. The negative amortization causes the unpaid interest to bear interest as though it were principal, called *compounding*.

The **all-inclusive trust deed** (AITD) variation is used more often in carryback transactions than money lending. Lease-options, land sales contracts and AITDs become popular in times of recession, increased long-term rates and tight credit.

The lease-option and land sales contract are *security devices* which do not use a note to evidence the debt. Instead, they are themselves evidence of the debt owed the seller on the price. However, the lease-option and the land sales contract contain greater legal risks than the AITD, due to their recharacterization as mortgages, while producing the same financial function and tax result as the AITD.

The AITD "wraparound" note typically calls for the buyer to pay the carryback seller constant monthly installments of principal and interest. The carryback seller then pays installments due on the underlying (senior) trust deed note from the payments received on the AITD.

Another variation, the *shared appreciation mortgage* (SAM), is designed to help sellers attract buyers during times of tightening mortgage money, prior to a general decline in real estate sales, when no lack of buyers exists. The SAM is an example of a split-rate note. [See Figure 1, **first tuesday** Form 430]

Under a SAM note, the buyer pays an initial fixed interest rate, called a "floor" or "minimum" rate. The floor rate charged is typically two thirds to three fourths of the prevailing market rate but not less than the **applicable federal rate** (AFR) for reporting imputed interest.

Figure 1

first tuesday *Form 430 -*
Shared Appreciation Note - Installment - Contingent Interest Extra

SHARED APPRECIATION NOTE
Installment — Contingent Interest Extra

Prepared by: Agent ____________________ | **Phone** ____________________
Broker ____________________ | **Email** ____________________

$______________, dated ______________, 20_______, at ________________________________, California.

Items left blank or unchecked are not applicable.

1. In installments, I promise to pay to ____, as the Payee , or order,
at ____,
1.1 the sum of ____ DOLLARS,
1.2 with interest from ____________, 20______, on unpaid principal,
1.3 at the rate of ______ % per annum, plus any contingent interest provided for below.

2. Principal and interest payable in installments of $_______________, or more,
2.1 on the ____________ day of every ☐ month ☐ quarter ☐ year, beginning on the ____________ day of ____________, 20______,
2.2 and continuing until ____________, 20______, when the principal is due and payable.

3. CONTINGENT INTEREST:
3.1 Contingent interest shall be due on any of the following events:
a. maturity of the note;
b. resale of the property;
c. prepayment of the note; or
d. acceleration of the note.
3.2 Contingent interest shall be payable only from the net appreciated value of the secured property.
3.3 Contingent interest is computed as follows:
a. ______% of the net appreciated value of the property when the contingent interest is due; or
b. ______% annually on the original note amount, compounded annually at the aggregate note rate until the contingent interest is paid.

4. NET APPRECIATED VALUE:
4.1 The net appreciated value is the fair market value of the property when the contingent interest is due, less Payor's original acquisition costs, the value of additional capital improvements made by Payor, and customary resale costs including a brokerage fee.
4.2 Payor's original acquisition cost of the property includes the total purchase price, plus customary escrow and recording fees, title insurance premiums, notary fees, legal fees, credit report fees, appraisal fees, broker fees, loan origination or assumption fees, inspection fees and all other customary costs incurred in acquiring the security.
a. Payor must document the above costs within two months after close of escrow by delivering their escrow closing statement and other supporting documents to Payee.

5. FAIR MARKET VALUE:
The fair market value of the property shall be determined as follows:
5.1 When the security is not being resold, by appraisal on the following method:
a. Payor to obtain and pay the costs of an appraisal of the property value prepared by a certified residential real estate appraiser within three months prior to payment of the contingent interest.
5.2 On resale of the property, the sales price shall be deemed the fair market value, unless Payee contests the sales price in writing within 10 days after receipt of written notification of the sale from Payor. If Payee contests the sales price, fair market value will be the greater of the sales price or the amount determined by appraisal under Section 5.1.
5.3 Payor and Payee may at any time establish the fair market value by mutual agreement.

6. ADDITIONAL CAPITAL IMPROVEMENTS:
Payor may have the value of capital improvements added to his cost of the property by mailing to Payee a cost breakdown for approval prior to undertaking the improvement. If approval is withheld, the value of capital improvements shall be determined by appraisal at the time of improvement under Section 5.1.

— — — — — PAGE ONE OF TWO — FORM 430 — — — — —

— — — — — PAGE TWO OF TWO — FORM 430 — — — — —

7. PREPAYMENT: (check one only)
7.1 ☐ For owner-occupied, one-to-four residential units: If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.
7.2 ☐ For all other residential and nonresidential property: Privilege is reserved to prepay all or part of this note at any time by paying principal, accrued interest, and six months' unearned interest.

8. LATE PAYMENT:
If any installment payment under this note is not paid within ______ days after its due date, a late charge of $______________ shall be incurred by Payor and be due and payable upon Payee's demand.

9. BALLOON/FINAL PAYMENT NOTICE:
☐ This note is to contain the following balloon payment notice provision (mandatory on sales of four-or-less residential units): This Note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 days and not more than 150 days before any balloon payment is due.

10. GENERAL PROVISIONS:
10.1 Any unpaid interest shall be added to the principal and thereafter bear interest as the principal.
10.2 Should default occur on any installment of principal or interest when due, then the whole sum of principal and interest shall be due at the option of Payee.
10.3 In any action to enforce this agreement, the prevailing party shall receive attorney fees.
10.4 Principal and interest payable in lawful money of the United States of America.
10.5 This note is secured by a DEED OF TRUST.

Payor's Name: ______________________________	Payor's Name: ______________________________
Payor's Signature: ___________________________	Payor's Signature: ___________________________
Payor's Name: ______________________________	Payor's Name: ______________________________
Payor's Signature: ___________________________	Payor's Signature: ___________________________

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In return, the carryback seller receives part of the property's appreciated value as additional interest, called *contingent interest*, when the property is sold or the carryback SAM is due.

Financial aspects

A note documents the terms for repayment of a loan or the unpaid portion of the sales price carried back after a down payment, including:

- the amount of the debt;
- the interest rate;
- the periodic (monthly) payment schedule; and
- any due date.

The amount of the note carried back on an installment sale is directly influenced by whether the carryback is:

- an AITD note; or
- a regular note.

The face amount of an AITD note carried back by a seller will always be a greater amount than had a regular note been negotiated in any given sales transaction. The AITD note includes the amount of the wrapped loans while a regular note is only for the amount of the seller's equity remaining after deductions of the down payment.

Interest rate limitations on loans

California's usury law limits the interest rate on non-exempt real estate loans to the greater of 10% or the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%. [Calif. Constitution, Article XV]

A non-exempt loan is usurious if the promissory note provides for an interest rate exceeding the ceiling rate on the day the note is agreed to. Other benefits received by the lender may make a loan usurious when the face amount of the note does not appear usurious. [See Chapter 68]

All real estate loans **made or arranged** by a real estate broker, however, are exempt from the usury restriction. [Calif. Const. Art. XV §1]

Since seller carryback notes are not money loans but rather extensions of credit on a sale, they are not covered by the usury laws. [**Boerner** v. **Colwell Company** (1978) 21 C3d 37]

The trust deed

In most carryback transactions, the buyer gives the seller a trust deed lien on the real estate sold to provide security for payment of the portion of the price left to be paid.

The trust deed attaches the debt to the property as a lien on the property. The trust deed is recorded to give notice (and establish priority) of the seller's security interest in the property. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

A trust deed alone, without a monetary obligation for it to attach to the described property, is a worthless trust deed. Although the note and trust deed executed by a buyer in favor of the seller are separate documents, a trust deed can only exist when it secures an existing promise to pay or perform any lawful act. [**Domarad** v. **Fisher & Burke, Inc.** (1969) 270 CA2d 543]

Even though separate documents, the note and trust deed are for the same transaction and are considered one contract to be read together. [Calif. Civil Code §1642]

Satisfaction of the debt

The promissory note, once signed by the borrower and delivered to the lender or its agent, represents the existence of a debt. [Calif. Code of Civil Procedure §1933]

When a secured debt has been fully paid, the trust deed securing the debt must be removed from title to the secured property. [CC §2941]

The trustee under the trust deed will require the original note and a request for reconveyance from the lender before the trustee will release the lender's trust deed lien from the real estate, a process called *reconveyance*.

If the original note has been lost or the note holder cannot be located, the trustee will require a bond be posted in its place before **reconveyance**.

If the lender or the trustee fails to reconvey the security interest after full payment, either may be subject to a civil fine of $300, a criminal fine of $400 and/or six months imprisonment. [CC §§2941, 2941.5]

Chapter 56 — Adjustable rate notes

This chapter considers the use of an adjustable rate note (ARM) by a carryback seller during periods of low short-term interest rates when it is foreseeable those interest rates will rise.

Editor's note — This chapter does not apply to ARMs originated by private lender loans secured by owner-occupied, one-to-four unit residential properties as they, unlike carryback ARM notes, are heavily regulated by state law and federal agencies. [Calif. Civil Code §1916.7]

For a further discussion of this topic, see Chapter 7 of Real Estate Finance.

Chapter 56 Outline

Bargaining for real estate's inflation hedge
Negotiating a carryback ARM

Chapter 56 Terms

Adjustable rate mortgage (ARM)	*Installment sale*
Fixed rate mortgage (FRM)	*Interest rate margin*

Bargaining for real estate's inflation hedge

The seller of a parcel of any type of real estate agrees to carry back a note secured by the property. The sale will take place during a phase in the business cycle when real estate related interest rates are rising or are likely to rise in the future.

The seller and the seller's agent have indications that both short-term and long-term interest rates are going to maintain (or begin) an upward swing over the next few years of national economic or inflationary upturn.

The **resale value** of a fixed-rate note negotiated before the rise in rates will be decreased by any future rise in interest rates. A future loss of value in the note is an event any seller wants to consider avoiding. The seller wants to be able to sell or pledge the note in the future without having to deal with a loss in its value caused by rising interest rates which were foreseeable.

Can the carryback seller receive both the current interest rate charged for fixed-rate loans and any future increase in interest rates without renegotiating the interest rate on his carryback note every year or two based on due-dates or call options?

Yes! A carryback seller and his prospective buyer can agree to an *adjustable rate mortgage (ARM)* note. **ARM** provisions give the carryback seller both the current market rate for fixed-

ARM Checklist

When negotiating an adjustable rate mortgage (ARM) loan or carryback note, the listing agent, borrower and private lender or carryback seller will need to establish:

- the amount of the note;
- the initial interest rate on the note;
- the frequency of interest rate adjustments;
- the index and margin to be used to adjust the interest rate;
- the life-of-loan floor and ceiling interest rates;
- the amortization period for setting the amount of the periodic principal and interest payments; and
- the due date for the final/balloon payment.

rate loans and a rate adjustment on each future increase in short-term interest rates. Thus, he reduces his risk of a loss in the value of his note due to inflation. [See Form 433 accompanying this chapter]

For the carryback seller to benefit from any future increases in short-term interest rates, the terms negotiated for the note need to include a provision for periodic adjustments of interest, based on:

- a rise in figures in the index selected, such as the twelve month treasury average; and
- an agreed-to margin representing the spread between the current figure in the selected index and the market rate charged by private lenders for fixed-rate loans.

Negotiating a carryback ARM

An agent solicits a seller of income producing property to list the property for sale on terms which include a carryback of short-term junior financing by the seller, called an *installment sale*. The carryback will assist a buyer in financing the price he will pay to purchase the property. The current market rate for a comparable fixed-rate loan made by a second trust deed lender is, say 10%.

The seller wants to offset the financial risk of what he believes will be a future money market of rising interest rates driven by consumer inflation fears, asset inflation with its excess demand for mortgage funds and corporate financing, and massive government borrowing in lieu of tax revenues.

ADJUSTABLE RATE NOTE SECURED BY DEED OF TRUST

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

NOTE: Not for use by private lenders on owner-occupied, one-to-four unit residential property. [Calif. Civil Code §1916.7]

$______________, DATED ____________, 20______, at ______________________________, California.

Items left blank or unchecked are not applicable.

1. In installments, I ____, as the Payor,
   1.1 promise to pay to ______________________________________, as the Payee, or order,
   1.2 at ____,
   1.3 the sum of ______________________________ dollars ($______________) plus interest.
2. Interest to accrue from ____________, 20______ on the unpaid principal at an initial yearly rate of _______ % through the last day of the month of ____________, 20______.
   On the first day of the following month and every ☐ month ☐ quarter ☐ year thereafter, until paid, interest will be adjusted to the note rate calculated as follows:
   2.1 The note rate is the sum of the Index Figure and the Margin, rounded to the nearest one-hundredth of one percent (0.01%).
   2.2 The index used to calculate the note rate of interest will be the ☐ 11th Federal Home Loan Bank Board District cost-of-funds, or ☐ ______________________________________.
   The Index Figure for the third month prior to the month of the adjustment date will be used to calculate the adjusted interest rate. If the selected index is no longer available, the Note Holder will select a new index which is based on comparable information.
   2.3 A margin of ______% will be added to the index figure to determine the note rate of interest.
   2.4 The interest rate of this note shall not rise above ______ %.
   2.5 The interest rate of this note shall not fall below ______ %.
3. Principal and interest is payable in monthly installments on the first day of each month, beginning ____________, 20______, and continuing until ____________, 20______, when the principal is due and payable.
   3.1 The initial installment of principal and interest is to be $______________.
   3.2 Monthly installments payable beginning the next month following each note rate adjustment will be changed to an amount sufficient to pay off the remaining principal at the adjusted note rate over an amortization period of ______ years from the date interest first commenced on this note.
   3.3 Borrower may prepay all or part of the outstanding principal amount at any time without penalty.
   3.4 Principal and interest payable in lawful money of the United States.
   3.5 Each payment to be credited first on interest then due and the remainder on principal.
   3.6 In the event this note evidences a money loan and the interest on this note exceeds the limit allowed by usury law and the loan is not exempt from usury laws, excess interest will be applied to the principal.
4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note Holder.
5. ☐ Special provisions attached.
6. In any action to enforce this agreement, the prevailing party shall receive attorney fees.
7. This note is secured by a trust deed.

Payor: ______________________________ Payor: ______________________________

Signature: ___________________________ Signature: ___________________________

Payor: ______________________________ Payor: ______________________________

Signature: ___________________________ Signature: ___________________________

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To hedge against rising rates, the seller wants an adjustable rate of interest on any note he agrees to carry. The initial interest rate sought by the seller for the first six months will be the current market rate for private loans. When the initial interest period runs, the note rate will adjust upward every six months to match any periodic increase in rates as reflected by an index tied to short-term interest rates for treasury bills. The carryback seller wants his interest rate adjustments to be set by figures from an index based on short-term rates. He believes short-term rates will be driven upward by the Federal Reserve (Fed) more rapidly than long-term rates, and remain up for many months after the decline of long-term rates as the Fed fights inflation.

In addition to an **index figure**, an *interest rate margin* must be set to make the periodic adjustment in the interest rate on the carryback note. The amount of the margin will be added to the index figure to establish the periodic interest rate on the carryback note, called the *note rate*.

When negotiating the amount of the **margin**, consider basing it on the percentage spread between:

- the interest rate currently charged by private lenders on comparable fixed-rate second trust deed loans; and

- the current figure from an index for short-term treasury rates (one-year T-Bills) or lender cost-of-funds (11th District cost-of- funds).

Thus, with the amount of the margin set for the life of the carryback note, the carryback seller's yield on the note will change every sixth months as the index figures issued by the government change, reflecting any increase or decrease in short- term interest rates.

In our example, the current market rate for comparable fixed-rate loans originated by private lenders is 10%. The index agreed to is the one-year constant maturity treasury index, which is at 4%. The margin agreed to is 6%, the difference between the market rate on fixed-rate loans made by private lenders (10%) and the index figure (4%).

Thus, when short-term interest rates increase as the economy or inflation picks up, and the index figure rises as a result, the interest rate on the note will be adjusted accordingly.

Editor's note — In periods when short-term interest rates have peaked or are in decline, as occurred in the early-1980s, in 1989, in 2001, and again in 2007, it is often advantageous for buyers to finance purchases by using an ARM.

ARM financing allows their payments to drift downward with declining short-term interest rates. Later, when the note rates on fixed rate loans are at a reduced level, the buyer then refinances the ARM with a fixed-rate loan to provide permanent long-term financing if he intends to continue owning the property.

Conversely, the moment ARM rates move downward to the benefit of buyers, carryback sellers should arrange fixed-rate notes with prepayment penalties to cover losses of future earnings due to an early payoff during a period of reduced rates, part of the normal process during a recession.

Chapter 57 Prepayment penalties

This chapter discusses the financial consequences experienced by an owner of real estate on the prepayment of a debt secured by the property when the note evidencing the debt includes prepayment provisions.

For a further discussion of this topic, see Chapter 9 of Real Estate Finance.

Chapter 57 Outline

Debt reduction as a costly privilege
Economic reality
Enforceable penalties

Chapter 57 Terms

Annual percentage rate	*Qualified mortgage*
Due-on clause	*Real Estate Settlement Procedures Act*
Prepayment penalty	*Secondary mortgage market*

Debt reduction as a costly privilege

An owner of real estate who wants to reduce or pay off principal on a debt evidenced by trust deed note **before** it is due by its terms may have previously agreed to an extra or additional charge the lender can levy to reduce or pay off the debt, called a *prepayment penalty*.

The penalty agreement is included in the promissory note, not a provision in the trust deed, since it relates to the payment of the debt, not the care and maintenance of the real estate.

The unscheduled prepayment of any principal on a debt before it is due by the terms of the note is considered a **privilege**. If a prepayment penalty provision is agreed to, a lender can exact a bonus on each exercise of the privilege, whether the reduction is a portion or all of the principal remaining on the debt. [See Form 418-2 accompanying this chapter]

Historically, prepayment penalties were used by lenders in an effort to prevent the loss of interest during the period following the receipt of principal until the funds were re-lent to another borrower.

California courts have embraced a number of rationales which support lender enforcement of the prepayment penalty, including:

- **Administrative costs**: The net costs and the loss of profit (earning) incurred by a lender on the unscheduled reduction of principal [**Hellbaum** v. **Lytton Savings and Loan Association** (1969) 274 CA2d 456];

- **Lag time**: The loss of interest income due to money sitting idle between payoff and re-lending [**Lazzareschi Investment Company** v. **San Francisco Federal Savings and Loan Association** (1971) 22 CA3d 303];

- **Lender profitability**: Use of the prepayment penalty as a device to enable lenders to maintain a generous loan portfolio yield [Lazzareschi Investment Company, *supra*];

- **Lender expectations**: When a lender is committed to a long-term return of funds, prepayment disrupts its expectations [Lazzareschi Investment Company, *supra*]; and

- **Loss due to falling market rates**: Income lost due to prepaid funds being re-lent at lower interest rates than originally bargained. [**Sacramento Savings and Loan Association** v. **Superior Court** (1982) 137 CA3d 142]

Economic reality

For each justification in support of the need to receive prepayment penalties offered by lenders, a counter-argument exists:

1. **Administrative costs**: Costs incurred by lenders when re-lending the funds by making new loans are always recovered up-front. Items, such as loan origination fees and charges received by a lender to re-lend the funds from a payoff, always offset lender costs incurred to re-lend principal to fund new loans.

2. **Lag time**: Cash on hand does not sit idle in today's lending institutions. Lenders used to have a saying, "Lettuce rots if it sits on the shelf." Unlike lettuce, prepaid funds are promptly re-invested in short-term securities until placed again in long-term mortgages.

3. **Lender profitability**: When lenders call loans on the transfer of the secured property, they do so only because they can re-lend the money at higher rates. They welcome the prepayment of fixed-rate loans in markets of rising interest rates since principal repaid and re-lent increases their portfolio yield and helps maintain profitability, the prepayment penalty earnings being a bonus.

   While it can be argued lenders should have the right to collect prepayment penalties to compensate for losses incurred when re-lending funds in a declining interest market, this argument is inapplicable when interest rates are rising.

   However, prepayment penalty provisions are enforced on premature principal payments in both rising and falling interest rate markets.

4. **Lender expectations**: The *Hellbaum* and *Lazzareschi Investment Company* decisions stress the belief that having made long-term commitments, lenders can expect long-term benefits.

PREPAYMENT OF PRINCIPAL PROVISIONS

Penalties and Discounts

Prepared by: Agent ______________________________ **Phone** ______________________
Broker ______________________________ **Email** ______________________

DATE _____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____________, 20______ at ______________________________, California,

1.2 entered into by____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as ____
____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For owner-occupied, one-to-four residential units*:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and nonresidential property*:

☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of ______% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

2.4 *Discount for early payoff provision*:

☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a ______% discount, plus accrued interest and future advances, for the period expiring _____________, 20______.

Payor's name ______________________________	Payor's name ______________________________
Signature__________________________________	Signature__________________________________
Payor's name ______________________________	Payor's name ______________________________
Signature__________________________________	Signature__________________________________

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When viewed against lenders' adjustable rate lending practices and many of the portfolio yield claims made with regard to the due-on controversy, this argument fails to withstand analysis.

Lenders expect loans to be paid **prior to maturity**. Lenders take the risk of prepayment into consideration when setting interest rates or evaluating the worth of a portfolio of loans. The standard industry long-term projection shows the average mortgage prepays by its twelfth year.

In California, the average in the 1990s was a mere five years due to several refinancing episodes as rates constantly declined, and again in the mid-2000s as home values doubled or tripled and refinancing conditions converted real estate equities into ATMs.

Such turnover generates profits from loan origination fees, points and interest rate adjustments. It is reasonable to assume prudent lenders base their annual profit projections on portfolio turnover.

Further, with the predominant *secondary mortgage market*, many institutional lenders pool and sell their mortgages on an advantageous change in interest rates, and generally do not own the mortgages with the intent of obtaining long-term income.

To justify prepayment penalties by citing lenders' expectations of long-term returns seems unjustified when viewed against **adjustable rate loan** (ARM) lending and loan turnover history.

5. **Loss due to declining market rates**: For the declining market argument to succeed, penalties would be appropriate only when market rates drop below that of the prepaid loan, and only when the various front-end charges and points accruing over the life of the loan as well as the lender's cost of funds at the time of the prepayment are also taken into consideration.

   Thus, it seems that all but the rarest situations, such as a catastrophic fall in long-term interest rates without a corresponding and immediate fall in short-term rates, prevent lenders from experiencing losses simply because of an early payoff.

Enforceable penalties

Prepayment penalties became strictly regulated in 2010 under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.

Prepayment penalties are **prohibited** on mortgage loans which are not *qualified mortgages*.

A **qualified mortgage** is any loan that falls within the parameters of the *Real Estate Settlement Procedures Act (RESPA)* (consumer loan secured by an owner- or non-owner-occupied one-to-four unit residential property).

Further, prepayment provisions are also prohibited on the qualified mortgages which:

- have an **adjustable interest rate (ARM)**; or

- have an *annual percentage rate (APR)* exceeding the average prime offer rate in a comparable residential mortgage loan by:
  - **1.5%** or more on a first mortgage with a principal equal to or less than the conforming loan limits set by Freddie Mac;
  - **2.5%** or more on a first mortgage with a principal more than the conforming loan limits set by Freddie Mac; and
  - **3.5%** or more on a second or other subordinate mortgage.

Prepayment penalties on qualified mortgages cannot exceed:

- **3%** of the outstanding balance on the loan during the 1st year of payment beginning on the closing date of the loan;
- **2%** of the outstanding balance on the loan during the 2nd year of payment beginning on the closing date of the loan;
- **1%** of the outstanding balance on the loan during the 3rd year of payment beginning on the closing date of the loan; and
- **0%** after the initial three years following the closing date of the loan.

Further, a lender may only charge a **prepayment penalty** if:

- the prepayment penalty does not extend beyond two years after the date of the loan's closing;
- the prepayment penalty does not apply when the same lender later funds the refinancing of the property triggering the prepayment penalty;
- at closing, the borrower's total monthly debt are less than 50% of his verified gross income; and
- the monthly payments do not change or adjust during the first four-year period after closing. [12 Code of Federal Regulations §§1026.32(d)(6)-(7)]

Chapter 58 — Late charges and grace periods

This chapter analyses the purpose of late charge provisions in trust deed notes and limitations on their enforcement by carryback sellers and private lenders.

For a further discussion of this topic, see Chapter 11 of Real Estate Finance.

Chapter 58 Outline

Chapter 58 Terms

Breach	*Late charge provision*
Final/balloon payment	*Non-material breach*
Impound account	*Notice of default*

Elements of a late charge

To establish the right to enforce collection of a late charge, the following conditions must be met by the noteholder:

- a **late charge provision** exists in the note [See Form 418-1 accompanying this chapter];
- a scheduled payment is **delinquent**;
- a **notice of amounts due** is delivered to the payor assessing the late charge and demanding its payment;
- the **dollar amount** of the late charge is within the limits set by applicable *lender statutes* and *reasonableness standards*; and
- **accounting requirements** for semi-annual and annual reports have been complied with.

The failure of an owner to pay a late charge of a proper amount and for which a demand has been made on the delinquency of a payment is a *non-material breach* of the note and trust deed. As a non-material breach, the failure to pay late charges cannot be the sole monetary basis for initiating a foreclosure by recording a notice of default (NOD).

Distinctions exist in the treatment of late charges permitted for private lender loans as compared to charges permitted for seller carryback paper. For private lenders, late charges on loans **secured by single family residences** (SFRs) are treated differently than when they are secured by other types of property. Also, the amount of the late charge a private lender may impose is further controlled by whether or not the loan was **made or arranged** by a broker.

The negotiation of late charge provisions

Late charge provisions are included in all notes used by **institutional lenders**. Late charge provisions sought by institutional lenders are generally non-negotiable, due primarily to lender adherence to established uniformities, such as ceilings set by statute or pooling arrangements in the secondary mortgage money market. However, the inclusion of late charge provisions in notes carried back by **sellers** or originated by **private lenders** is never automatic and is left to negotiation.

Before a late charge provision is included in a note, the charge must be agreed to. When the late charge is one of the carryback note provisions agreed to in a **purchase agreement**, it is then proper for escrow to be instructed to include the applicable late charge provision in the note prepared for signatures. [See **first tuesday** Form 150 §8.1]

The provision and the late charge amount

For a late charge provision to be complete, it must include:

- the **amount** of the late charge;
- the **duration of any grace period** following the due date before a payment becomes delinquent; and
- a **requirement for notice** from the trust deed holder to impose – assess – the late charge and make a demand for its payment. [See Form 418-1]

The amount of a late charge imposed on the delinquency of a payment on a debt secured by real estate, except private loans secured by an owner-occupied single family residence (SFR) or loans made or arranged by a broker, must be *reasonably related* to money losses incurred by the creditor (carryback seller and non-SFR private lenders) due to the delinquency. [Calif. Civil Code §1671; see Form 418-1 §2.3]

While late charge provisions are triggered by the delinquency of a periodic payment or the final/balloon payment, the late charge agreed to is not automatically due. Unless the delinquency is immediately preceded or followed by a notice imposing the charge and demanding its payment, the charge is *waived*. [CC §2954.5]

LATE PAYMENT PROVISIONS

Addendum to Promissory Note

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

DATE__________, 20_____, at ______________________________________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note
   1.1 ☐ of same date, or dated __________, 20_____, at ______________________, California,
   1.2 entered into by ____, as the Payor,
   1.3 in favor of ____, as the Payee, and
   1.4 secured by a trust deed on real estate referred to as ______________________
   ____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:
   2.1 *For an owner-occupied, single family residence:*
   ☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.
   2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:
   ☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.
   2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans:*
   ☐ If any installment on this note is not received ☐ when due, or ☐ within ______ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $______________, or ☐______% of the delinquent principal and interest installment amount.
   2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:
   ☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.
   2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans:*
   ☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of ______%.
   2.6 *For compounding interest on a default on other than one-to-four residential units:*
   ☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

Payor's name ______________________	Payor's name ______________________
Signature ______________________	Signature ______________________
Payor's name ______________________	Payor's name ______________________
Signature ______________________	Signature ______________________

FORM 418-1 03-11

Scan this QR-Code for a PDF of the Form!

The reasonable amount of **monetary losses** collectible as a late charge include:

- the actual *out-of-pocket expenses* incurred in a reasonable collection effort; and
- the *lost use* of the principal and interest (PI) portion of the delinquent payment.

Money losses incurred in a reasonable effort to collect a late payment include the cost of forms, envelopes and postage for mailing the notice, and the administrative time spent by individuals to do so prior to recording a *notice of default (NOD)*.

Even if the late charge provision is void as excessive and constituting a financial windfall to the carryback seller or private lender, the buyer is still liable for the seller's or lender's out-of-pocket money losses resulting from the delinquency, if assessed and payment demanded. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

When a scheduled payment is not received prior to its becoming delinquent, a late charge provision in an installment note properly calls for either:

- an additional one-time fixed fee stated as a dollar amount; or
- the accrual of interest on the amount of the delinquent PI payment.

Late charge notice

To collect a late charge for the delinquent payment on a note secured by **any type of real estate**, the carryback seller or private lender holding the note must notify the property owner of the charge and **make a demand** for its payment.

Private lenders must give notice and make a demand for the late charge in a *timely manner* by use of either:

- a billing statement or notice sent for each payment prior to its due date stating the late charge amount and the date on which it will be incurred; or
- a written statement or notice of the late charge amount due concurrent with or within ten days after mailing a notice to cure a delinquency. [CC §2954.5(a)]

The notice of amounts due or the billing statement, whichever is used, must include the exact amount of the late charge or the formula used to calculate the charge. [CC §2954.5(a)]

If the private lender fails to initiate collection of the late charge for any delinquency by a notice and demand for its payment, the lender **waives** his right to collect a late charge on that payment. However, failure to comply with the late charge notice requirements on a delinquency does not waive the private lender's right to enforce the late charge provision on future delinquencies. [CC §2954.5(e)]

Late charges on SFRs

A private lender makes a loan to a homeowner secured by his single family residence (SFR) he occupies as his principal residence. The note calls for monthly installments of *principal and accrued interest (PI)* to be paid on the first day of each month. The loan is not made or arranged by a broker.

The note contains a **late charge** provision allowing:

- a ten day grace period after the due date for the lender to receive each monthly payment before it is delinquent; and
- a late charge of 6% of the delinquent PI installment on written notice and demand for its payment. [See Form 418-1 §2.1]

A monthly payment is not received on or before the eleventh day of the month, the expiration of the ten day grace period on the tenth day after the due date.

The lender sends the homeowner a **written notice** of amounts due demanding payment of the delinquent installment and the agreed-to 6% late charge. The homeowner makes the delinquent payment but refuses to pay the late charge.

Is the private lender's demand for the late charge enforceable?

Yes! The installment was **not received** by the expiration of the ten day grace period following the due date of the installment. Thus, it is delinquent and a late charge is collectible on notice and demand.

Ten days is the **minimum grace period** allowed for a private lender secured by an owner-occupied SRF, even if the homeowner agrees to a shorter grace period, or no grace period is agreed to. [CC §2954.4(a), (b)]

The late charge amount on a private lender loan which is **not made or arranged** by a broker and is secured by an owner-occupied SFR is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5. [CC §2954.4(a), (e)]

What if the payment was post-marked as mailed within the grace period but was received by the lender after the grace period expired?

Mailing the installment within the grace period does not qualify the payment as timely paid. The payment must be **actually received** by the carryback seller, lender or collection agent no later than the last day of the grace period and be immediately negotiable. [**Cornwell** v. **Bank of America National Trust and Savings Association** (1990) 224 CA3d 995]

Conversely, the note may require the owner to tender the payment by employing a particular method of payment, such as by mail. Then the payment is considered received when the owner complies with the method of payment, such as placing the payment in the mail, even if the note-holder never receives it. [CC §1476]

Made or arranged by brokers

When a licensed real estate broker makes or arranges a loan as or for a private lender, the 6% limit for late charges established for loans secured by owner- occupied single family residences (SFRs) does not apply, nor do other reasonableness standards. [CC §2954.4(e)]

For private lender loans **made or arranged** by a real estate broker, called a *brokered loan*, and secured by any type of real estate, the late charge is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5. [Calif. Business and Professions Code 10242.5(a); see Form 418-1 §2.2]

Also, if the private lender loan made or arranged by a broker contains a due date for a **final/balloon payment**, a late charge may be assessed on the final/balloon payment if it is not received within ten days after its due date. [See Form 418-1 §2.4]

The amount of the late charge assessed on a delinquent final/balloon payment for a brokered loan is limited to the amount of the 10% late charge due (calculated) on regularly scheduled monthly installments. However, the late charge on a final/balloon payment for a brokered loan may be **charged for each month** the payment remains delinquent. In addition, interest at the note rate (or default or statutory rate) accrues and is payable with the final/balloon payment. [Bus & P C §10242.5(c)]

Like an owner-occupied SFR loan, an installment on a private lender loan made or arranged by a broker on any type of property is not late if paid (received by the lender) within ten days after the installment is due. [Bus & P C §10242.5(b)]

One charge per delinquency

For a private lender loan secured by an owner-occupied single family residence (SFR), or one made or arranged by a broker and secured by any type of property, the private lender cannot charge more than one late charge per delinquent monthly installment, no matter how many months the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b)]

Final/balloon payments untimely paid

When a **final/balloon payment** on a loan or an installment sale becomes delinquent, a private lender or carryback seller may enforce a *default rate* provision. A default rate increases the note rate on the remaining principal, unless the debt is secured by an owner-occupied single family residence (SFR) or is a broker-arranged loan. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701]

However, the default rate of interest must be reasonable and triggered only by the expiration of any grace period for delivery of the final payment. [Garrett, *supra*; see Form 418-1 §2.5]

Impound accounts

An *impound account* is a money reserve, also called an *escrow account*. The money in the account consists of the funds that the property owner advanced to the lender or carryback seller as an initial deposit, followed by regularly scheduled further deposits. From the impounded funds, the lender or carryback seller pays specified obligations the owner periodically owes on the property, such as:

- property taxes;
- insurance premiums;
- assessments for common area or easement maintenance;
- water stock; or
- bonded off-site improvements.

To fund the **impound account**, a pro rata amount of the costs anticipated to be incurred to pay *annual taxes*, assessments and i*nsurance premiums (TI)*, is collected each month along with the monthly principal and interest (PI) payments (collectively, **PITI**).

For late charge purposes, the tax and insurance portion - **impounds** - of the owner's monthly PITI payment must not be included in the formula for computing the amount of the late charge. The TI funds are the owner's money, accumulated by the carryback seller to pay obligations owed by the owner to others.

Enforcement of the late charge

Refusal or failure of an owner to meet a demand to pay a late charge agreed to in a trust deed note is a *non-material breach* of the note and trust deed. Thus, non-payment of a late charge by itself does not justify a call of the loan or initiation of foreclosure. [**Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

No lender or carryback seller is entitled to foreclose on an owner who has tendered all installments which are due, but has failed to pay outstanding late charges. Collection of late charges when no other monetary breach exists must be enforced by means other than foreclosure. Additionally, a private lender making a loan on any type of real estate is required to furnish the owner with a **semi-annual accounting** for the total amount of late charges due and unpaid during the accounting period. [CC §2954.5(b)]

For late charges on a carryback note secured by property improved with only a one-to-four unit family residence, the carryback seller must also provide the owner with an **annual accounting** statement detailing any late charges due and unpaid during the entire year. [CC §2954.2(a)]

Chapter 59 Balloon payment notices

This chapter presents the due date notice, its application to debts secured by one-to-four unit residential real estate, and the enforcement of due dates in trust deed notes.

For a further discussion of this topic, see Chapter 12 of Real Estate Finance.

Chapter 59 Outline

Notes containing a balloon payment
Balloon payment notice and due dates
Delivery and contents of the notice
Balloon payment disclosures

Chapter 59 Terms

Balloon payment	*Balloon payment notice*
Call provision	*Seller carryback disclosure*

Notes containing a balloon payment

A *balloon payment* is any final payment on a note which is an amount greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the balloon payment. [CC §§2924i(d)(1), 2957(b)]

Balloon payment notes are notes with due date provisions calling for an accelerated final payoff of the principal in a lump sum amount before the note balance has been fully amortized.

Also, a note has a final balloon payment if it contains a *call provision* giving the carryback seller or money lender the right to demand final payment at any time or after a specified time. [CC §§2924i(d)(2), 2957(c)]

Balloon payment notice and due dates

Not all notes with due dates require a balloon payment notice. [See **first tuesday** Form 419]

A due date notice provision is required to be included in balloon payment notes with a term exceeding one year if:

- the note is carried back by a seller and secured by a trust deed on one-to-four residential units; or

- the note evidences a money loan secured by a trust deed on an owner-occupied, one-to-four unit residential property.

A due date notice for a **final/balloon payment** is not required, unless agreed to by both parties, on transactions including:

- carryback notes secured by nonresidential real estate or residential real estate exceeding four units;
- money loans secured by any type of real estate except owner- occupied, one-to-four residential units;
- open-ended credit secured by any real estate; and
- construction loans for any type of improvements. [CC §2924i(b)(1), (3)]

The purpose for the use of the 90/150-day due date notice in any note is to remind the owner of the property of the final payment, and to give him an opportunity to refinance or pay off the note. It also sends a signal to the owner who is negotiating for an extension of the time for a payoff that the noteholder is not likely to extend the due date.

Delivery and contents of the notice

Carryback sellers and lenders must deliver the notice to the buyer or the current owner of the property personally, or by first-class certified mail to the property owner's last known address. The notice must be given at least 90 days, but not more than 150 days, before the due date. [CC §§2924i(c), 2966(a)]

If the notice is not delivered on time, the final due date of the loan is extended until 90 days after proper notice is given. No other terms of the note are affected. Thus, the accrual of interest and the schedule of repayments (and all other terms) on the note remain the same during the extended due date period. [CC §§2924i(e), 2966(b)]

The failure to deliver the notice does not invalidate the note or lessen the property owner's obligation to continue making the regular periodic payments. Non-delivery of the notice merely extends the date by which the property owner is obligated to pay off the note.

If the property owner defaults on a payment during the due-date extension period, the noteholder may initiate foreclosure.

Balloon payment disclosures

Sellers who carry back notes containing balloon payments due more than one year after closing and are secured by one-to-four residential units, must initially estimate and disclose the amount of the balloon payment in the *Seller Carryback Disclosure Statement.* [See **first tuesday** Form 300]

The disclosure statement, if not prepared and attached to the purchase agreement, must be delivered before escrow closes.

Specifically, the carryback statement requires the buyer to be made aware of:

- the presence of a balloon obligation;
- the approximate amount of the balloon payment;
- any negative amortization; and
- the fact the buyer may not be able to refinance the balloon payment when it is due. [CC §2963; see **first tuesday** Form 300]

The Trust Deed

Chapter 60 — Trust deed characteristics

This chapter portrays the status of the parties to a trust deed and discusses the nature and purpose of the trust relationship.

For a further discussion of this topic, see Chapter 13 of Real Estate Finance.

Chapter 60 Outline

A security device and a lien
Parties to the trust deed
The trustee's authority
The beneficiary is the lienholder
A trust deed acts only as a lien
Extinguishing the relationship
Failure to reconvey on payoff

Chapter 60 Terms

Beneficiary	*Promissory note*
Collateral	*Security device*
Guarantor	*Trustor*
Lien	*Trustee*
Possessory right	*Trustee's authority*
Legal fiction	*Reconveyance*

A security device and a lien

Financing, in its most basic form, involves a borrower or a buyer who signs and delivers a *promissory note* to the lender or seller as **evidence of the debt** owed for money lent or credit extended as a carryback.

However, the promissory note itself is only a promise to pay as agreed, not a **guarantee or other assurance** the debt evidenced by the note will be repaid.

A **guarantee** is an agreement entered into by a person not obligated under the note to which obligates the person as a *guarantor* of the borrower's or buyer's performance on the note. In essence, the guarantor has agreed to buy the note on its default. [See **first tuesday** Form 439]

In real estate loan transactions, lenders want other assurance the debt owed by the borrower will be repaid. Thus, lenders require borrowers to provide real estate as *collateral* to **secure the performance** of the borrower's promise to pay should he default on the note.

Figure 1 ***first tuesday*** *Form 450*

Long Form Trust Deed and Assignment of Rents - Securing a Promissory Note

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

LONG FORM TRUST DEED AND ASSIGNMENT OF RENTS

Securing a Promissory Note

Prepared by: Agent ____________________ **Phone** ____________________

Broker ____________________ **Email** ____________________

This Deed of Trust, made this ______________ day of ____________________, 20______,
between ____, as the Trustor,
whose address is ____,
(Number and street) (City) (State) (Zip)
______________________________________, a California corporation, as the Trustee, and
____, as the Beneficiary.

1. Trustor hereby **IRREVOCABLY GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE,**

1.1 The real property in the City of ____,
County of ______________________________________, California, referred to as:

1.2 TOGETHER WITH the rents, issues and profits of the real property, subject to the provisions of §3.4, herein to collect and apply the rents, issues and profits,

1.3 **For the purpose of securing payment of:**

a. the indebtedness evidenced by a promissory note of same date executed by Trustor, in the sum of $____________;

b. any additional sums and interest hereafter loaned by Beneficiary to the then record Owner of the real property, evidenced by a promissory note or notes, referencing this Deed of Trust as security for payment;

c. the Beneficiary's charge for a statement regarding the secured obligations requested by or for Trustor; and

d. the performance of each agreement contained in this Deed of Trust.

— — — — — — — — — — — — — — — — — — — *PAGE ONE OF THREE — FORM 450* — — — — — — — — — — — — — — — — — — —

— — — — — — — — — — — — — — — — — — — *PAGE TWO OF THREE — FORM 450* — — — — — — — — — — — — — — — — — — —

2. To protect the security of this Deed of Trust, Trustor agrees:

2.1 **CONDITION OF PROPERTY** — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

2.2 **HAZARD INSURANCE** — Trustor will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which Beneficiary requires insurance. The insurance shall be maintained in the amounts and for the periods Beneficiary requires. The insurance carrier providing the insurance shall be chosen by Trustor, subject to Beneficiary's approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Beneficiary, and contain loss payable clauses in form acceptable to Beneficiary. Beneficiary shall have the right to hold policies and renewals.

In the event of loss, Trustor shall give prompt notice to the insurance carrier and Beneficiary. Beneficiary may make proof of loss if not made promptly by Trustor. Beneficiary may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Trustor fails to reconstruct, Beneficiary may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

2.3 **ATTORNEY FEES** — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Beneficiary or Trustee; and to pay all costs and expenses, including cost of evidencing title and attorney fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear.

2.4 **TAXES AND SENIOR ENCUMBRANCES** — To pay at least 10 days before delinquency: all taxes and assessments affecting the property, including water stock assessments when due, all encumbrances, charges and liens, with interest, on the property which are or appear to be senior to this Deed of Trust; and all expenses of this Deed of Trust.

2.5 **ACTS AND ADVANCES TO PROTECT THE SECURITY** — If Trustor fails to make any payment or to perform any act provided for in this Deed of Trust, then Beneficiary or Trustee may, without obligation to do so, and with or without notice or demand upon Trustor, and without releasing Trustor from any obligation under this Deed of Trust:

a. make or do the same to the extent either deems necessary to protect the security, Beneficiary or Trustee being authorized to enter upon the property to do so;

b. appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Beneficiary or Trustee;

c. pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this Deed of Trust.

In exercising the power of this provision, Beneficiary or Trustee may incur necessary expenses, including reasonable attorney fees.

Trustor to immediately pay all sums expended by Beneficiary or Trustee provided for in this Deed of Trust, with interest from date of expenditure at the same rate as the principal debt hereby secured.

3. It is further mutually agreed that:

3.1 **ASSIGNMENT OF DAMAGES** — Any award of damages made in connection with:

a. condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. injury to the property by any third party;

is assigned to Beneficiary, who may apply or release the proceeds of such award in the same manner and with the same effect as above provided for the disposition of hazard insurance proceeds.

3.2 **WAIVER** — By accepting payment of any sum due after its due date, Beneficiary does not waive Beneficiary's right to either require prompt payment when due of all other sums or to declare a default for failure to pay. Beneficiary may waive a default of any agreement of this Deed of Trust, by consent or acquiescence, without waiving any prior or subsequent default.

3.3 **DUE-ON-SALE** — Should Trustor sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, then Beneficiary may, at Beneficiary's option, declare all sums secured by this Deed of Trust immediately due and payable.

— — — — — — — — — — — — — — — — — — — *PAGE TWO OF THREE — FORM 450* — — — — — — — — — — — — — — — — — — —

— — — — — — — — — — — — — — — — — — — *PAGE THREE OF THREE— FORM 450* — — — — — — — — — — — — — — — — — — —

3.4 **ASSIGNMENT OF RENTS** — Trustor hereby assigns and transfers to Beneficiary all right, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this Deed of Trust.

a. Prior to a default on this Deed of Trust by Trustor, Trustor shall collect and retain the rents.

b. On default by Trustor, Beneficiary shall immediately be entitled to possession of all unpaid rents.

3.5 **ACCELERATION** — If payment of any indebtedness or performance of any agreement secured by this Deed of Trust is in default, Beneficiary may at Beneficiary's option, with or without notice to Trustor, declare all sums secured immediately due and payable by:

a. commencing suit for their recovery or for foreclosure of this Deed of Trust; or

b. delivering to Trustee a written notice declaring a default with demand for sale; a written Notice of Default and election to sell to be recorded by Trustee.

3.6 **TRUSTEE'S SALE** — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with Calif. Civil Code §2924 et seq.

3.7 **TRUSTOR'S OFFSET STATEMENT** — Within 10 days of Trustor's receipt of a written request by Beneficiary, Trustor shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of Beneficiary: the then owner of the secured property; the terms of the secured note, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured note is valid and the Trustor received full and valid consideration for it; and that Trustor understands the note and this Deed of Trust are being assigned.

4. ADDENDA — If any of the following addenda are executed by Trustor and recorded together with this Deed of Trust, the covenants and agreements of each shall incorporate, amend and supplement the agreements of this Deed of Trust (check applicable boxes):

☐ Owner-occupancy rider; ☐ All-inclusive trust deed addendum; ☐ ____________________;
☐ Impounds for taxes and insurance addendum; ☐ Private Mortgage Insurance (PMI) rider.

5. RECONVEYANCE — Upon written request from Beneficiary stating that all sums secured by this Deed of Trust have been paid, surrender of this Deed of Trust and the note to Trustee for cancellation, and payment of Trustee's fees, Trustee shall reconvey the property held under this Deed of Trust.

6. SUCCESSORS, ASSIGNS AND PLEDGEES — This Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary shall mean the holder and owner of the secured note, or, if the note has been pledged, the pledgee.

7. TRUSTEE'S FORECLOSURE NOTICES — The undersigned Trustor requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Trustor at the address herein set forth.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ____________, 20_____ Trustor: ______________________________________

Date: ____________, 20_____ Trustor: ______________________________________

STATE OF CALIFORNIA
COUNTY OF______________________________
On ______________________________ before me,
____
(Name and title of officer)
personally appeared ______________________
______________________________________,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ______________________________
(Signature of notary public)

(This area for official notarial seal)

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To secure payment of the debt by a parcel of real estate, a *security device* is used in the form of a trust deed agreement. The trust deed is the preferential method used to impose a *lien* on real estate. [See Figure 1, **first tuesday** Form 450]

The **lien** gives the lender or carryback seller both the right and the obligation to foreclose on the real estate on a default in either the note of the security device–the trust deed

The trust deed, by its words, purports to convey legal title to a neutral person, called a *trustee*. In law, the title is not transferred at all. Instead, a **lien** is created to encumber on the owner's title and establish the property as security for the debt.

By the use of the trust artifice, title to the property is theoretically held by a trustee as a middleman, **in trust** on behalf of the owner and for the benefit of the lender or carryback seller.

Enforcement of the trust provision is permitted by the courts as a legal fiction, unnecessarily employed to invoke the privately contracted for power-of-sale foreclosure provisions which are fully controlled by statute and used in lieu of a judicial foreclosure.

Should the owner ever default on the note or trust deed, the middleman/trustee can be instructed by the lender to sell the property at a public auction to satisfy the debt.

A **trust deed lien** arrangement consists of:

- an identification of the parties;
- description of the real estate liened as security;
- an identification of the primary money obligation, usually evidenced by a separate note, which brought about the need for security;
- the terms of the lender's security interest which is the encumbrance on the property, limited to setting out the rights and obligations of the borrower and the lender solely in regard to the real estate; and
- the borrower's signature and notary acknowledgments.

Parties to the trust deed

The trust deed identifies three parties, each of whom has distinctly separate roles in the secured transaction:

1. The owner, called the *trustor*, who voluntarily imposes the trust deed lien on his property.
2. The middlemen, called the *trustee*, who holds the power of sale over the property.
3. The lender or carryback seller, called the *beneficiary*, who benefits from the trust deed lien encumbering the property.

The trustor who signs and delivers a trust deed to a lender or carryback seller must be the **owner** of the real estate interest encumbered when the trust deed is delivered. Delivery is usually accomplished by recording the trust deed with the county recorder, which also *perfects* its priority on title.

The owner creating a trust deed encumbrance on real estate usually is the borrower of money or buyer of the property in a credit sale. However, an owner can impose a trust deed lien on the title to his property to provide security for the performance of any lawful act he may have agreed to, or as security for another person's debt, including other individuals, a corporation, limited liability company (LLC) or partnership debt. [**Everly Enterprises, Inc.** v. **Altman** (1960) 54 C2d 761]

The owner's real estate interest which is encumbered can be less than the entire fee, such as a fractional co-ownership, leasehold interest or life estate in the property.

For example, a condominium owner, or any other property owner, can encumber his long-term leasehold interest under which he holds possession, even though some other person is the fee owner of the real estate. [Calif. Civil Code §§783, 1091, 2947]

Other real estate interests which can be encumbered besides the fee, leasehold, and life estates include beneficial interests of creditors in existing trust deeds, equitable ownership rights under land sales contracts, and purchase rights under options to buy.

As mentioned, the owner does not need to be the sole owner of an interest in the property to encumber his interest with a trust deed. For example, one tenant-in-common or joint tenant (except a husband or wife) can, unless agreed to the contrary with other co-owners, sell or encumber his individual ownership interest without the consent of his co-owner or co-owners. [**Thompson** v. **Thompson** (1963) 218 CA2d 804]

However, the trust deed lien created by the owner of a fractional interest in the real estate attaches only to the owner's interest in the property, not to the interests of his co-owners. [**Caito** v. **United California Bank** (1978) 20 C3d 694]

If community property is to be encumbered, both spouses must consent to the encumbrance of the community real estate interest, with the exception of attorney fees agreements in divorce proceedings. [Calif. Family Code §1102]

An off-record spouse who does not consent to an encumbrance can have a lien removed from the community property. To do so, the action must be filed within one year of the date the trust deed is recorded.

The trustee's authority

Despite the wording in the trust deed stating the trustor "hereby grants and conveys to trustee... the following real property...", the trustee receives no ownership or security interest in the real estate, and holds no legal right to any interest in the property. The trustee merely receives the **authority** to carry out the activities vested in the trustee by the power-of-sale provision in the trust deed lien held by the beneficiary. [**Lupertino** v. **Carbahal** (1973) 35 CA3d 742]

Under the trust deed, the trustee's only responsibilities concerning the property are:

- **to auction the property** at a public sale on notice from the lender of a default and election to sell; and

- **to reconvey title** to the owner and release the lender's lien on instructions from the beneficiary or the trustor.

The owner's *possessory right* (fee, leasehold, or life estate) to the property is not transferred to the trustee under a trust deed. The trustor, as the owner of the real estate, remains free to occupy, sell, lease or further encumber his property, subject to existing liens.

Any person other than the owner of the real estate may serve as trustee. This includes the beneficiary of the trust deed, be he lender or carryback seller. [**More** v. **Calkins** (1892) 95 C 435]

Some private lenders name their attorney or broker as the trustee. Most often, however, title and escrow companies unknowingly play the role of trustee in a particular transaction by virtue of the lender's use of regular trust deed forms the title companies distribute throughout the financial and brokerage industries.

The key difference between the trust deed's *legal fiction* as a trust and a genuine trust is that the trustee under a trust deed is designated without his knowledge or consent. A true trustee must consent to his appointment. [Calif. Probate Code §15600]

Under a trust deed lien, the trustee is treated as **non-existent** until the lender elects to foreclose by a trustee's sale or is required to reconvey (release) the beneficiary's security interest in the property.

The position held by the trustee in a trust deed functions merely as the passive repository of an auctioneer's power to conduct a private sale as agreed to in the trust deed. The trustee's conduct is in nearly all aspects completely controlled by statutes. [**Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268; CC §2924 et seq.]

When the trustee is called on by the beneficiary to actually carry out its responsibilities under the power-of-sale provision, it is required to act impartially.

Thus, a trust deed lien does not create a trust relationship between the parties to the trust deed, even though words of trust and conveyancing are used.

Even though the trustee's instructions to sell or reconvey come primarily from the beneficiary, the trustee is regarded as a *common agent* and bears a responsibility to both the beneficiary and the trustor to absolutely follow the strict statutory foreclosure scheme. [**Kerivan** v. **Title Insurance and Trust Company** (1983) 147 CA3d 225]

The beneficiary is the lienholder

The **beneficiary**, such as a lender or carryback seller, is the person entitled to the performance of the promised activity referenced in the trust deed as the purpose for obtaining the security, usually the repayment of a debt evidenced by a note.

The beneficiary, like the trustee, receives no ownership interest in the property. But unlike the trustee, the beneficiary **holds an interest** in the property, a security interest called a *lien*.

Thus, the beneficiary has the power to instruct the trustee (who could be himself) to sell the secured property on behalf of the beneficiary (himself). In turn, the trustee has authority from both the trustor and the beneficiary under the power-of-sale provision in the trust deed to sell the property in conformance with the statutory scheme on a declaration from the trust deed beneficiary. [Prob C §§16000, 16420(a)(1)]

A trust deed acts only as a lien

The modern California trust deed gives the beneficiary a lien as a security interest in the real estate. The trust deed authorizes the sale of the property by a trustee's sale under the power-of-sale provision to enforce collection of the secured debt. With the exception of the power-of-sale provision, the trust deed is identical to its predecessor, the mortgage. [**Bank of Italy Nat. Trust & Savings Ass'n** v. **Bentley** (1933) 217 C 644]

For example, a lender is a beneficiary under a trust deed on property which secures a construction loan made to the owner of the property. The owner defaults on loan payments and the lender instructs the trustee under the trust deed to notice the default and proceed with a foreclosure sale, called a *trustee's sale*.

Before the trustee's sale is held, a contractor seeking to foreclose on a mechanic's lien sues and records a lis pendens, claiming an interest in title to the property. However, the mechanic's lien foreclosure action references only the trustee's interest in the real estate as the interest claimed by the contractor to satisfy his money demands.

At the trustee's sale, the lender acquires title to the property. Later, the contractor, under his mechanic's lien foreclosure action, obtains a judgment and is awarded the trustee's interest in the property. The contractor, to enforce collection of money under his judgment through a sheriff's sale, completes his judicial foreclosure and becomes the owner of the trustee's interest in the secured property. The contractor does not pursue any lien rights against the lender's interest in the property as the new owner under the trustee's deed.

Does the contractor's enforcement of his judgment against the trustee's interest under the trust deed give him any interest in the property?

No! A trustee under a trust deed has no interest in the property and thus holds nothing of value to be attached. The contractor failed to pursue the lender, who was the only person (other than the owner) with an interest in the property, both before and after the trustee's sale.

The contractor's judgment against the trustee only attached to the trustee's interest under the trust deed — an interest limited to the power to sell the property at an auction for the benefit of the lender, which it did. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

Under a trust deed, title to the property appears to be held by a trustee. But the deed conveying title into the purported "trust" is a **legal fiction**. The sole purpose for recording a trust deed is to **perfect** the lender's security interest in the property. The trust deed conveyance only imposes a lien on the real estate and carries with it none of the possessory rights of ownership to the collateral.

Extinguishing the relationship

The trust deed ceases to exist when its purpose as security for a debt ends.

Thus, once the beneficiary has received the full amount of money he is entitled to receive under the note and trust deed, any later claim of the beneficiary to a security interest in the property or activity of the trustee (except reconveyance) is invalid.

Removing the trust deed from the title to the property on ending the debt relationship between the owner and the creditor is accomplished in one of three ways:

- **foreclosure** by issuance of a trustee's deed or sheriff's deed;
- **full repayment** by reconveyance [See **first tuesday** Form 472]; or
- **mutual agreement** by a deed-in-lieu of foreclosure.

Foreclosure of the trust deed lien is accomplished by a public auction at a trustee's sale or sheriff's sale, the proceeds of which are applied to the debt.

Even if the price bid at the foreclosure sale is insufficient to fully satisfy the note, the foreclosure sale terminates the trust deed lien on the property sold by canceling the trust deed's effect on the title on issuance of the trustee's or sheriff's deed.

Full repayment of the debt requires the beneficiary to cause the trust deed to be reconveyed. Once the debt is fully repaid, the beneficiary delivers the original note to the trustee, together with a request for a reconveyance of title. In turn, the trustee records a *reconveyance* of the trust deed. [See **first tuesday** Form 472]

A trustee who erroneously reconveys when the owner is not entitled to a release of the lender's lien on the property is liable for the beneficiary's resulting money losses.

However, the beneficiary's monetary recovery from the trustee is limited to the market value of the secured property. [**Jeanese, Inc.** v. **Surety Title & Guaranty Co.** (1959) 176 CA2d 449]

On a **request for reconveyance,** the trustee will demand identification of the beneficiary and require the original note be marked paid. After recording the reconveyance, the trustee will deliver the note to the owner at the owner's request.

Unless the recorded trust deed lien expires earlier, the lien expires and is no longer enforceable by any means after the later of:

- ten years after the final maturity date contained in the recorded trust deed; or
- 60 years after the recording of the trust deed if the final maturity date cannot be ascertained from the recorded trust deed. [CC §882.020]

Failure to reconvey on payoff

Failure of the beneficiary or trustee to comply with mandatory reconveyance requirements results in liability for the owner's actual money losses, a penalty of $300 and criminal liability punishable by a fine of $400 and six months imprisonment. [CC §§2941, 2941.5]

Copies of lost or destroyed originals will be accepted from the beneficiary by the trustee for purposes of reconveyance if they are accompanied by:

- the beneficiary's sworn statement;
- an agreement to indemnify; and
- a lost instruments bond. [**Huckell** v. **Matranga** (1979) 99 CA3d 471]

As an alternative, the beneficiary may avoid unnecessary fees and bonds by substituting trustees — such as himself — to act as the trustee and reconvey the trust deed lien.

When the beneficiary refuses to reconvey on full satisfaction of the debt or cannot be located, the owner, as trustor, can obtain and record a corporate bond in the county where the encumbered property is located. The corporate bond is to be issued in a sum the greater of either:

- two times the amount of the original obligation, plus advances; or
- half of the compounded obligation plus interest. [CC §2941.7(a)]

The corporate bond must be accompanied by a declaration containing the name of the trustor and beneficiary, as well as the name and address of the individual making the declaration, generally the trustor. The declaration must state either:

- the obligation has been fully satisfied but the beneficiary cannot be located or refuses to reconvey; or
- a balance exists, including principal and interest, but the beneficiary cannot be located. [CC §2941.7(b)(4)]

The trustor must send a notice by certified mail to the trustee and the last beneficiary of record stating the trustor has recorded the bond and declaration. The notice must state the trustee may record a written objection to the release of the obligation. [CC §2941.7(b)(5)]

Also, the creditor and property owner may **mutually agree** to terminate the security interest evidenced by the trust deed lien with:

- a deed-in-lieu of foreclosure and reconveyance of the trust deed; or
- a substitution of security and reconveyance of the trust deed without first paying the debt in full.

Under a deed-in-lieu of foreclosure, the owner conveys his entire interest in the property to the beneficiary in exchange for the beneficiary canceling any remaining debt and reconveying the trust deed.

Thus, the trustor/beneficiary relationship between the owner and the creditor under the trust deed is terminated.

Chapter 61 — Due-on-sale regulations

This chapter clarifies the events which trigger a lender's due-on clause and analyzes the adverse socio-economic effects of due-on regulations on the real estate resale and equity loan markets.

For a further discussion of this topic, see Chapter 21 of Real Estate Finance.

Chapter 61 Outline

Chapter 61 Terms

Acceleration	*Inter-family transfer*
Due-on clause	*Inter vivos trust*
Equitable owner	*Pre-emption*
Garn Act	*Waiver by consent*

Rising rates bring lender interference

During the good times of upward sales volume, expanding mortgage origination and increasing absorption rates for available rented space, the marketplace functions at full throttle—a virtuous cycle. Social benefits of lending abound.

Every sales activity feeds on every other sales activity. No one seems to care about the excuses and inherent inefficiencies buried in the process.

Responsibility for all this frenzy lies solely with the gatekeepers to entry into real estate ownership, and relocation—the brokers and lenders. All other parties to a real estate transaction, being merely affiliated, provide closing services once the broker has located a buyer and the lender qualifies that buyer (and the property) for a purchase-assist loan. Singularly, these two events by these two guardians of real estate are the nucleus of a sale, and all else follows as support services.

During the good times of rising prosperity for all, buyers will put up with the onerous threshold of entry procedures maintained by these gatekeepers. In the rush to do deals, all the numerous steps to ownership seem to be justified, or are simply overlooked as necessary tedium to get in on the act.

However, when, as always it must, the cause of a recession - short-term interest rates rise to outrun inflation - dampens enthusiasm (as occurred in 1989, 2000, 2005), lending standards tighten.

The restrictions on entry posted by the brokers and lenders, burdensome in the first place, are actually tightened to discourage the able and ready buyers who then become unwilling to put up with both the hassles of entry or relocating and the regime of higher rates and increased credit standards: A **vicious cycle** which takes years to unwind after it bottoms.

Enter *due-on-sale* restrictions (and efforts to get around brokers). As a result, socio-economics decline.

One of the burdens on the mobility of title necessary to sell real estate which restricts the ease with which a buyer and seller can make a deal is the *due-on clause* you will find buried within the copy of all trust deeds held by lenders. During boom years, buyers can easily qualify for a new loans and sellers are relatively unconcerned about the size of the prepayment penalty on their mortgages that the due-on clause is not an issue.

However, as the boom turns to bust and buyers want to buy property, the most effective financing arrangement is to take over the seller's loan. However, the lender as the gatekeeper generally says no to any type of loan takeover or assumption—"I want my repayment penalty and I can re-lend the money at higher current rates." Thus, what was not a burden and not a factor inhibiting deals made during the boom becomes a noose about the seller's neck tying him to his property without a way through the MLS to get out from under the loan—or the property.

Lender interference authorized by federal mortgage law

Generally, all lenders and carryback sellers are allowed to enforce their due-on sale clauses in trust deeds on nearly all transfers of an interest in any type of real estate. [12 United States Code §1701j-3, Garn-St. Germain Depository Institutions Act of 1982 (Garn)]

Thus, federal mortgage law deprives Californians (and residents of numerous other states) of their state law right to convey real estate subject to trust deed liens without the lender interfering with the transfer of ownership, unless the lender can show the buyer lacks creditworthiness, a federal legislative process called *pre-emption*.

The occurrence of an event which triggers due-on enforcement automatically allows the lender to:

- **call the loan**, demanding the full amount remaining due be paid immediately, also known as *acceleration*; or

- **recast the loan**, requiring a modification of the loan's terms as a condition for the lender's consent to a transfer, called a *waiver by consent*.

The *Garn Act* encourages lenders to allow buyers to assume real estate loans at existing rates, but provides lenders no incentives for doing so. The congressional intent in passing the *Garn Act* was to **pre-empt state law restrictions** of due-on enforcement, allowing the lenders to increase their profits, a process called *deregulation*.

However, the enforcement of the due-on clause by lenders was not intended to occur at the expense of permitting **excessive lender interference** with real estate transactions, whether they are sales, leases or further encumbrances. [12 USC §1701j-3(b)(3)]

Yet, when the Federal Home Loan Bank Board (now the Office of Thrift Supervision (OTS)) issued **due-on regulations** to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights.

The OTS regulations allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence exceptions. No encouragement or guidelines were established in the regulations as proffered by congress for lenders to consent to loan assumptions or to limit interference in commonplace transactions.

Since lenders often disregard the law in their trust deed lending and enforcement practices, it is hard to imagine why they would comply with a mere congressional request, a **"moral risk"** created by congressional reaction to lender misconduct. In the absence of any regulatory obligation, lenders use their due-on clauses to maximize their financial advantage over owners by calling or recasting loans on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market by adjusting the rate of interest.

Economic recessions and recoveries

In times of stable or falling interest rates, lenders, when requested, usually permit assumptions of loans at the existing note rate, unless a prepayment penalty clause exists. Lenders have no financial incentive to recast loans, or call and re-lend the funds at a lower rate when interest rates are dropping in the marketplace.

However, in times of steadily rising rates, lenders seize any event triggering the due-on clause as an opportunity to increase the interest yield on their portfolio. Once the due-on clause is triggered, the lender requires the loan be recast at current market rates as a condition for allowing an assumption, lease or further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on trust deeds becomes increasingly difficult to transfer as interest rates rise, contributing to the "imprisoning" of an owner in his own home as he is unable to relocate. Lender due-on interference is virtually guaranteed since the interference results in an increase in the lender's portfolio yield which permits them to remain solvent, if not the owner.

However, the *inhibiting effect* on buyers during recessions when buyers are required to assume existing financing at higher interest rates has an adverse economic effect on real estate sales, as

"It has recently come to our attention..."

Trust deed called or recast at lender's option

Events triggering the due-on clause

Sale:

- transfer of legal title (grant or quitclaim deed);
- land sales contract or holding escrow;
- court-ordered conveyance; or
- death.

Lease:

- lease for more than three years; or
- lease with an option to buy.

Further encumbrance:

- creation or refinance of a junior lien; or
- foreclosure by junior lienholder.

Transfers not triggering due-on enforcement (owner-occupied, four-or-less residential)

- creation of junior lien where owner continues to occupy;
- transfers to spouse or child who occupies;
- transfer into inter vivos trust (owner obtains lender's consent and continues to occupy);
- death of a joint tenant; or
- transfer on death to a relative who occupies.

well as the availability of private junior financing and long-term leasing. Ultimately, as rates and lender interference rise, many buyers, equity lenders and long-term tenants are driven out of the market, which further depresses property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, leaving owners with no (read: negative) equity in the property. It is a vicious cycle which evolves into a dramatic increase in loan foreclosures, the antithesis of the profit motive for automatic lender enforcement of the due-on clause.

Due-on interference was an obscure issue during the 25-year period (1982 through 2007) after *Garn* became law. During this period, fixed mortgage rates declined from 15% to 5% as managed by the Federal Reserve Bank, the earnings of buyers increased (but not as fast as inflation was rising), inflation dropped, and mortgage money became more plentiful. All that was reversed commencing in 2007.

Due-on-sale

Due-on clauses are most commonly known as *due-on-sale* clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the lender's due-on clause is a sale of property which is subject to the lender's trust deed lien.

The due-on clause is triggered not only by a transfer using and recording a standard grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, whether or not it is recorded. Examples include a land sales contract, lease-option sale, or other alternative carryback devices, such as an all-inclusive trust deed (AITD).

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed. However, the seller on a contract (for deed) retains title as security for the carryback debt owed by the buyer rather than use a trust deed lien to evidence his security interest.

Thus, the buyer becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession is transferred, triggering the due-on clause in any existing trust deed (and reassessment). [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term when coupled with the grant of an option to purchase to the tenant. [12 Code of Federal Regulations §591.2(b)]

Due-on-further encumbrance

An owner-occupant of a single family residence (SFR) subject to a first trust deed applies for an **equity loan** to be secured by a second trust deed on his property. The first trust deed contains a due-on clause.

The loan broker tells the owner he is concerned about due-on enforcement by the senior lender, since the execution of a second trust deed will convey a security interest in the property by encumbering it with a lien. On inquiry, the owner informs the broker he will continue to occupy the property as his residence.

The broker correctly assures the owner the second trust deed encumbrance will not trigger the senior lender's due-on clause, as long as the owner continues to occupy the residence. Due-on enforcement based on a further encumbrance of an owner- occupied, one-to-four unit residential property is not permitted. Equity loans are a source of consumer funds which stimulate the economy. [12 CFR §591.5(b)(1)(i)]

However, on real estate other than an owner- occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing lender's waiver of its due-on clause triggers the due-on clause, giving the lender the right to call or recast the loan.

Thus, junior financing without a waiver of the senior lender's due-on clause becomes a risky enterprise for trust deed investors in times of rising interest rates. Increasing market rates give trust deed lenders a powerful incentive to call loans on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

Here, the modification of the first trust deed note without the consent of the junior carryback seller does not result in a change in trust deed priorities since the existence of the second trust deed note is in violation of the due-on clause in the first trust deed.

When the secured property is sold and the seller accepts a second trust deed without receiving the lender's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the first trust deed lender to avoid further subordinating the interest of the holder of the unconsented-to junior lien by recasting the first trust deed note. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

Due-on-foreclosure

A parcel of real estate is subject to a first trust deed lien and second trust deed lien to which the first consented. The property owner defaults on the first trust deed. The junior trust deed holder reinstates the first trust deed and forecloses on the second, acquiring the property at the trustee's sale. At all times the second trust deed holder kept the first trust deed current.

The senior lender informs the junior lender, who now owns the property, that it is calling its loan due, based on the transfer of the property by trustee's deed.

Can the senior lender call its loan due based on the completion of foreclosure by the second trust deed lender?

Yes! A senior lender may call a loan due on completion of the **foreclosure sale** by a junior lender or carryback seller on any type of real estate. A *trustee's deed* on foreclosure is considered a voluntary transfer by the owner, since the power of sale authority in the junior trust deed was agreed to by the owner of the real estate.

However, the due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, but also by any involuntary foreclosure, such as a tax lien sale. [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien, whether the transfer be voluntary or involuntary. [12 CFR §591.2(b)]

The risk of a senior lender enforcing its due-on clause on a trustee's sale by the junior lender has a **debilitating effect** on the availability of junior trust deed loans and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt should they be forced to foreclose on the real estate. [**Pas** v. **Hill** (1978) 87 CA3d 521]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner even if title was vested in a revocable inter vivos trust. However, as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause, on the condition the relative becomes an occupant of the property. [12 CFR §591.5(b)(1)(v)(A)]

Also, where two or more people hold title to one-to-four unit residential property as joint tenants, the death of one **joint tenant** does not trigger due-on enforcement as long as the surviving joint tenant currently occupies the property. [12 CFR §591.5(b)(1)(iii)]

In all other transfers, the death of a vested owner, joint tenant or other co-owner will trigger the lender's due-on clause.

Thus, due-on enforcement is **triggered on death** by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which is not currently occupied by any surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and

- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

A married couple occupies a residence which is vested in the name of the husband and owned as his separate property. The residence is subject to a trust deed containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the **property settlement** to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the lender?

No! Federal due-on regulations bar due-on enforcement on transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property. [12 CFR §591.5(b)(1)(v)(C)]

However, if the acquiring spouse chooses to lease the residential property to tenants for any length of time rather than occupy it, the lender can call or recast its loan.

Also, the due-on clause is not triggered by an owner's transfer of his one-to-four unit residential property to a **spouse or child** who occupies the property. [12 CFR §591.5(b)(1)(v)(B)]

This inter-family transfer exception for four-or-less residential property applies only to transfers from an owner to a spouse or child. For instance, any transfer from a child to a parent to provide housing for the parent triggers due-on enforcement.

Finally, consider an owner-occupant of one-to-four unit residential property who transfers the property into an *inter vivos trust*, naming himself as beneficiary. The owner continues to occupy the property after transferring title into the trust, commonly known as a living trust.

The owner **notifies the lender** he will be transferring title into the trust vesting. The owner agrees to give the lender notice of any later transfer of his beneficial interest in the trust or change in occupancy of the property as requested by the lender.

Would this transfer into a living trust trigger the due-on clause in a trust deed encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust. [12 CFR §591.5(b)(1)(vi)]

To meet regulations, the owner must provide means **acceptable to the lender** by which the lender will be given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the lender's approval of the notice provision, the lender may call the loan due.

The notification provision requires the owner to first obtain the lender's consent before transferring the property into a trust vesting.

Also, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the lender can call or recast the loan.

Chapter 62 Mortgage assumptions: formal and subject-to

This chapter explores the financing procedures available to a buyer when negotiating to take over an existing loan which encumbers the seller's property.

For a further discussion of this topic, see Chapter 22 of Real Estate Finance.

Chapter 62 Outline

Loan takeovers by buyers
The subject-to transaction
Nonrecourse debt
Recourse real estate loans
Buyer-seller assumption
Novation

Chapter 62 Terms

Assumption agreement	*Recourse*
Beneficiary statement	*Release of liability*
Formal assumption	*Retroactive interest differential*
Hold harmless agreement	*Subject-to assumption*
Novation	*Subject-to transfer*
Purchase-money debt	*Substitution of liability*

Loan takeovers by buyers

On the sale of a parcel of real estate, any existing financing encumbering the property may remain of record and be taken over by a buyer under one of four procedures:

- a **formal assumption** between the lender and the buyer;
- a **subject-to assumption** between the seller and the buyer;
- a **subject-to transfer** of ownership without an assumption agreement of any type; and
- a **novation** between the lender, seller and buyer.

The subject-to transaction

A subject-to transaction is initially structured by use of a financing provision in a purchase agreement which calls for the amount of an existing loan to be part of the purchase price the buyer is to pay for the property. The financing provision states the buyer is to take title to the property subject to the existing loan. [See **first tuesday** Form 150 §§5 and 6]

The seller's representation of the terms and condition of the loan is confirmed by the buyer during escrow on escrow's receipt of the lender's **beneficiary statement**. The buyer can rely on the beneficiary statement for future payment schedules, interest rates and loan balances in spite of the lender's attempts to conditionalize the use of the beneficiary statement on the buyer's assumption of the loan.

Buyers occasionally do not instruct escrow to order a beneficiary statement, fearing the notice of the sale may cause the lender to **call or modify** the loan after escrow closes. The seller's most recent loan payment receipt or loan statement might then be used as the source of loan information. However, the buyer must be aware the lender is not bound by the payment statements as it is bound by the beneficiary statement.

Some buyers acquire their ownership rights under **unrecorded sales documents**, such as lease-option agreements or land sales contracts. Thus, the seller and buyer completely avoid conveyances, escrow, title insurance, and other customary transfer activities until they can either work out an assumption or originate new financing. However, these unrecorded sales documents do trigger due-on clauses and reassessments, as well as create risks of loss inherent in an unrecorded transaction that leave room for misunderstandings about who owns the property.

During periods when current market interest rates are comparable to or lower than the note rate on an existing loan:

- a **beneficiary statement** should be ordered to confirm the loan amount and loan terms;
- the change of ownership conveyance should be **recorded and insured**; and
- the conveyance should promptly be brought to the **lender's attention** so it cannot wait and later call the loan when rates rise by claiming the transfer went undisclosed.

Conversely, during periods of rising or high interest rates, as compared to the note rate on an existing loan, the lender is often not notified of a subject-to sales transaction. Notice of the transaction would allow the lender to gain financially from a call or recast of the loan at the seller's and buyer's expense.

However, the lender can enforce its due-on clause and call the loan on its *future discovery* of any sale, regardless of how the sale is structured.

Also, on a later discovery of the transfer, any brokers, attorneys or accountants whose **primary objective** in negotiating the sales transaction was to induce the buyer and seller into avoiding the due-on clause may be liable to the lender (in tort) for any *retroactive interest differential* (RID) lost by the lender based on market rates at the time of the transfer.

A *hold harmless agreement* from the seller or buyer would be appropriate for providing indemnity to the agents and brokers negotiating the undisclosed transaction. [See Chapter 61]

The seller of property, sold either subject-to or by an assumption of the seller's loan, should be concerned about his liability for the loan after it is taken over by the buyer. Seller liability depends on whether the loan is a **recourse or a nonrecourse loan**, unless the lender's loss is a result of its error on a beneficiary statement or a payoff demand. [See Chapter 71]

Nonrecourse debt

A seller is not liable for a deficiency on the foreclosure of a *purchase-money* debt taken over under any procedure by the buyer, since they are nonrecourse debts.

Purchase-money obligations secured by real estate include:

- seller carryback financing on the sale of any type of real estate which becomes the sole security for the carryback note;

- a loan or debt which funded or financed the purchase of an owner-occupied, one-to-four unit residential property [Calif. Code of Civil Procedure §580b]; and

- a loan made for the construction of an owner-occupied, single family residence (SFR), and perhaps a loan made to improve the structure (the legal status of dwelling improvement loans remains uncertain).

A lender may only resort to the secured property by foreclosing on it to recover the balance due when a default occurs on a **purchase-money loan**. [CCP §580b]

Even if the secured property has insufficient remaining value to satisfy the balance of the purchase-money loan, the lender cannot hold the original borrower or a subsequent assuming buyer personally liable on the nonrecourse note for the deficiency in the property value (unless the lender may recover from the buyer who inflicts waste on the property).

On the take-over of a purchase-money loan by a buyer, the loan retains its original non-recourse purchase-money characteristics, regardless of whether the buyer takes title subject-to or assumes the loan, or a novation occurs. [**Jackson** v. **Taylor** (1969) 272 CA2d 1]

Thus, a non-occupying buyer who takes over a purchase-money loan under any procedure is entitled to anti-deficiency protection. In contrast, **purchase-assist** financing originated by a non-occupying buyer of any type of residential property, including one-to-four unit residential property, would be a recourse loan, not a purchase-money loan.

However, while the lender may have no recourse to the buyer, if the loan is insured by the Federal Housing Administration (FHA) and the Veterans Administration (VA), the FHA or the VA have recourse to the borrower who signed the note for losses on a foreclosure and resale of the property. [See Chapter 66 and 67]

Recourse real estate loans

Recourse loans are all loans not classified as **purchase-money loans**, as reviewed above.

When property is sold and its title is conveyed to a buyer **subject-to** an existing recourse loan, the seller remains liable for any deficiency on the recourse loan should the buyer fail to pay. [**Braun** v. **Crew** (1920) 183 C 728]

Further, unless the buyer enters into an **assumption agreement** with either the seller or the lender, a subject-to buyer is not liable to either the seller or the lender for a drop in the property's value below the loan balance (unless the buyer damages the property to an extent which decreases its value, called *waste*). [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590; CC §2929]

However, if the subject-to buyer and the lender enter into an assumption agreement which significantly modifies the terms of the recourse loan without the seller's consent, the seller cannot be held liable for the loan. [Braun, *supra*; CC §2819]

Buyer-seller assumption

A seller can reduce his risk of loss on a buyer's takeover of a **recourse loan** by negotiating the adoption of a provision in the purchase agreement which requires the buyer to enter into an **assumption agreement** with the seller.

A buyer-seller assumption agreement is not to be confused with a so-called *formal assumption* between the buyer and a lender.

The buyer-seller assumption agreement, agreed to in the purchase agreement and prepared in escrow, is a promise given by the buyer to the seller to perform all the terms of the loan taken over by the buyer on the sale. [See Form 431 accompanying this chapter]

The assumption agreement gives the seller the right to collect from the buyer the amount of any deficiency judgment a recourse lender might be awarded against the seller in a judicial foreclosure. To be enforceable by the seller, the assumption agreement must be in writing. [CC §1624]

Although the buyer's promise to pay the loan under a buyer-seller assumption agreement is given to the seller, the buyer also becomes liable to the recourse lender under the legal doctrines of *equitable subrogation* and *third-party beneficiaries*. [Braun, *supra*; see Form 431 §6]

Even though the buyer, upon entering into any type of assumption agreement, takes over the primary responsibility for the recourse loan, the seller remains **secondarily liable** to the lender. The seller's risk of loss arises when the buyer fails to pay the recourse loan and there is a lack of market value remaining in the property to cover the loan amount. [**Everts** v. **Matteson** (1942) 21 C2d 437]

ASSUMPTION AGREEMENT

Unsecured and Subrogated

Prepared by: Agent ____________________________ **Phone** ______________________
Broker ____________________________ **Email** ______________________

DATE: ____________, 20_____, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This assumption agreement is entered into by

1.1 ____, as the Buyer,

1.2 and ____, as the Seller,

1.3 regarding Buyer's acquisition of real estate referred to as ____________________________________
____.

2. FIRST TRUST DEED NOTE:

2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated ________________________,

2.2 executed by ____, as the Trustor,

2.3 in which ____ is the Beneficiary,

2.4 recorded on _______________________, as Instrument No.__________________, in the Official Records of ____ County, California, and

2.5 given to secure a promissory note of the same date for the principal sum of $______________.

3. SECOND TRUST DEED NOTE:

3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated _______________________,

3.2 executed by ____, as the Trustor,

3.3 in which ____ is the Beneficiary,

3.4 recorded on _______________________, as Instrument No.__________________, in the Official Records of ____ County, California, and

3.5 given to secure a promissory note of the same date for the principal sum of $______________.

AGREEMENT:

4. Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).

5. Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).

6. This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).

7. Should Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) shall become immediately due at the option of the holder of this assumption agreement.

7.1 On default, Seller shall become subrogated to the interest of Beneficiary under the defaulted note and trust deed.

8. In any action to enforce this agreement, the prevailing party shall receive attorney fees.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:____________, 20_____	Date:____________, 20_____
Seller: ____	Buyer: ____
Seller: ____	Buyer: ____

FORM 431 03-11

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Unlike the subject-to seller, the seller under the buyer-seller assumption agreement is entitled to be *indemnified* (held harmless) by the buyer for any losses the seller later incurs due to his continued liability on the recourse loan taken over by the buyer.

To avoid the delay in pursuing reimbursement from the buyer for any loss covered by the buyer-seller assumption agreement, sales negotiations calling for the buyer to enter into an assumption agreement with the seller may also call for the buyer to **secure the assumption** agreement by a *performance trust deed* carried back by the seller as a lien on the property sold. [See **first tuesday** Forms 432 and 451]

With a recorded trust deed held by the seller to secure the buyer's promise to pay the lender as agreed in the assumption agreement, any default by the buyer on the loan allows the seller to:

- demand the buyer to tender the entire balance remaining due on the assumed loan, subject to the buyer's right to reinstate the delinquencies; and
- proceed with foreclosure under the performance trust deed to recover the property and cure the default on the loan assumed by the buyer.

A buyer-seller assumption, like a subject-to transaction, does not alter the lender's right to enforce its due-on clause on discovery of the conveyance, unless the lender has waived its due-on rights by failing to call the loan or promptly act on a call after acquiring knowledge of the transfer of ownership.

Novation

The lender can enter into an agreement with both the buyer and the seller for the buyer's **assumption** of the loan and a **release** of the seller's liability, an agreement called a *novation* or *substitution of liability*, for which the lender charges a fee and may demand a modification of the loan terms.

On a buyer-lender assumption of a loan secured by an owner-occupied, one-to-four unit residential property, the lender is required to **release the seller from liability** for the loan assumed by the buyer. [12 Code of Federal Regulations §591.5(b)(4)]

A **novation agreement** is comparable to the existing lender originating a new loan with the buyer, except the trust deed executed by the seller remains of record and the note remains unpaid.

Thus, the lender under a novation agreement (or an assumption) will review the buyer's credit status, seek a modification of the interest rate to current levels, and charge an assumption fee which are all benefits a lender would have received on an origination of a new loan made to the buyer.

However, any lender collection of fees or an increase in the interest rate on the loan, called *portfolio yield*, defeats most of the advantages a buyer and seller have when taking title subject to an existing loan.

Chapter 63 Carryback financing in lieu of cash

This chapter introduces the concept of carryback financing and presents the various forms of documentation and risks of loss involved.

For a further discussion of this topic, see Chapter 25 of Real Estate Finance.

Chapter 63 Outline

Seller financing supports a greater price
Tax benefits and flexible sales terms
Variations on carryback financing
Carryback risks for the seller

Chapter 63 Terms

All-inclusive trust deed	*Private mortgage insurance*
Credit sale	*Risk premium*
Installment sale	*Wraparound security device*
Portfolio category income	

Seller financing supports a greater price

Most real estate sales involve the financing of some portion of the purchase price. During economic periods of plentiful and inexpensive mortgage money, the financing needed to fund the purchase of real estate is provided by an institutional or private lender, or more likely a mortgage banker.

However, when **economic conditions** tighten and reduce the availability of real estate loans to previously qualified buyers, a seller hoping to sell his property – and maintain his asking price must consider financing the purchase himself if he is to obtain a buyer.

Seller financing, also called an *installment sale* or *credit sale*, involves carrying back a note for the unpaid portion of the price remaining after deducting the down payment and the amount of the loan the buyer is assuming. Under most circumstances, the note will be secured by a first if the property is free of trust deed liens, or a second trust deed on the property being sold.

Thus, the carryback seller takes a secured creditor's position in the property for the amount of the price remaining to be paid, comparable to that of a mortgage lender. On closing, the legal rights and obligations of real estate ownership previously held by the buyer are shifted by the transfer to the buyer, while the seller carrying back a note and trust deed takes on the rights and obligations of a secured creditor.

Carryback financing offers considerable financial and tax advantages for both buyers and sellers of real estate when the installment sales transaction is properly structured.

The seller who offers a convenient and flexible financing package to prospective buyers makes his property more marketable and defers the tax bite on his profits. Qualified buyers who are rational are always willing to pay a higher price for real estate when attractive financing is available, regardless of whether it is provided by the seller or a mortgage lender.

Even the most qualified buyer will agree to a higher price when he can defer payment of the price through financing provided by the seller. This is especially true when the rate of interest on the carryback financing is competitive or below the rates lenders are charging on their purchase-assist loans, or when market prices (and rents) are trending upward which is economically equivalent to reducing the fixed rate of interest paid to the seller.

Tax benefits and flexible sales terms

Taxwise, it may be preferable for the seller to carry back a portion of the sales price, rather than be cashed-out on the sale. The seller taking a significant profit on a sale will be able to **defer taxes** on a meaningful amount of profit, spreading the payment of profit taxes over a period of years. Thus, he avoids a premature tax bite in the year of the sale on his non-exempt transaction.

Finally, the seller needs to understand the tax impact he will receive on his carryback financing is *portfolio category income*, without concern that the property sold was in another income category (passive/business/personal). The seller converts his real estate equity into a note which generates a constant cash flow. Otherwise he is cashed-out of his equity, pays profit taxes (unless exempt – §1031 – or *excluded* – principal residence) and reinvests what remains of his diminished after-tax sales proceeds.

The carryback note, in a rising market, typically provides for a higher interest yield than is available on other investments with a similar level of risk. The converse is true in a recessionary market. Additionally, the seller has first hand knowledge about his security – the property he is selling.

For buyers, seller carryback financing is a situation that generally offers a moderate down payment, competitive interest rates, less stringent terms for qualification than those imposed by lenders and no origination (hassle) costs.

Mortgage lenders typically require a minimum down payment of 20% for the buyer to avoid the additional burden of qualifying for *private mortgage insurance* (PMI). In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without outside influences, such as the requirements of the secondary mortgage market pools and PMI underwriters, which mortgage loan brokers and borrowers must contend with.

Also, the buyer is logically able to negotiate a lower-than-market interest rate in exchange for agreeing to the seller's higher-than-market asking price. The seller can have one or the other, but not both, if the buyer (or the buyer's broker) is knowledgeable and everyone involved is rational.

Variations on carryback financing

Seller financing is documented in a variety of ways, including land sales contracts, lease-option sales, sale-leasebacks and trust deed notes.

Legally, the note and trust deed is the most certain, as well as the most universally understood, of the various documents for structuring seller financing. Importantly, the note and trust deed are combined to evidence the debt owed the seller and provide security for repayment on the seller's grant deed conveyance. The **carryback documentation** consists of:

- a **promissory note** executed by the buyer in favor of the seller as evidence that a portion of the price remains to be paid for the real estate; and
- a **trust deed lien** on the property sold to secure the debt owed by the buyer as evidenced by the note.

The promissory note states the exact amount and terms for repayment of the debt the buyer owes to the seller. On the other hand, the trust deed creates a lien on the property which acts as security for payment of the debt. The trust deed requires the buyer to maintain the secured property, and gives the seller the power to foreclose through a trustee's sale should the buyer default on note payments or trust deed conditions.

The note and trust deed can be structured in regular or all-inclusive terms to meet the financial needs of the buyer and seller.

For instance, if the real estate is encumbered by a first trust deed which a qualified buyer can **assume** with the lender, the seller can carry back a regular note secured by a second trust deed. The note will be for the balance of the **seller's equity** which remains unpaid after deducting the buyer's down payment.

However, if the lender or servicing agent for the existing loan will not allow the loan to be assumed by the buyer, the buyer might arrange a new first trust deed loan to pay off the existing financing. Here, the lender will need to approve of the seller carryback of a second trust deed.

If the seller's borrowing power is greater than the buyer's, the seller might refinance the existing loan on the property himself and draw out a portion of his equity by placing new conventional financing on the property.

The buyer assumes the new loan and the seller carries back a regular note and junior trust deed for the remainder of his unpaid equity in the property.

Another alternative which reduces the seller's risk of loss and defers more profit taxes than a regular second trust deed note, is the all-inclusive trust deed (AITD) note, called a *wraparound security device*. In an AITD carryback arrangement, the amount owed the seller on the carryback note is always secured by a junior trust deed (AITD) lien on the property. However, the note secured by the AITD is for a dollar amount equal to the balance of the entire purchase price remaining unpaid after the down payment, and is not a regular note limited to the amount of equity remaining unpaid after the down payment.

Thus, the AITD "wraps" the senior financing by including the dollar amount of the first trust deed in the principal amount of the AITD note. The buyer makes payments to the seller on the AITD note. In turn, the seller continues to remain responsible for making payments on the senior loan from payments received on the AITD.

Carryback risks for the seller

A carryback seller must be aware he takes on the **role of a lender** in a carryback sale, with all the risks and obligations of a lender holding the seller's secured position.

Above all, the seller must be willing to accept the **risk of loss on a default** by the buyer in payments on the note or provisions in the trust deed. A seller who forecloses in an effort to recover the amounts owed on the carryback note from the property's value will be forced to advance cash to make payments on the senior trust deed loan. Also, a risk of loss due to impairment of the security exists, allowing for foreclosure, should the buyer default on trust deed provisions for the payment of taxes, assessments and insurance premiums.

Costs incurred in foreclosing and reselling the property can quickly turn a low-downpayment, high-interest-rate sale into a cash drain for the seller.

Also, the seller must understand a carryback note is *nonrecourse paper*. Thus, the seller will be barred from obtaining a money judgment from the buyer for any part of the carryback debt not satisfied by the value of the property – the deficiency. [Calif. Code of Civil Procedure §580b]

On a default by the buyer, the carryback seller could suddenly find himself returned to his original position — owning property he no longer wanted to own and still subject to the senior trust deed. Further, the seller will incur out-of-pocket costs for:

- foreclosure;
- carrying the property;
- any reduction in property value or property taxes for reassessment;
- a modified (higher) interest rate on the old loan (foreclosure triggers the due-on clause); and
- profit taxes on any previously untaxed principal in the down payment.

As with any creditor, if the **risk premium** built into the price, down payment and interest rate on the carryback note is sufficient, the benefits of carryback financing outweigh the risks of loss.

Lender financing

Chapter 64 Conventional financing for a sale

This chapter reviews the procedures used by a transaction agent for obtaining conventional financing to fund the purchase of a principal residence.

For a further discussion of this topic, see Chapter 36 of Real Estate Finance.

Chapter 64 Outline

Chapter 64 Terms

Buyer capacity	*Real Estate Settlement Procedures Act*
Community property	*Tenant improvement*
Good faith estimate	*Transaction agent*
Loan application	*Truth-in-Lending Act*
Loan-to-value	*Uniform Residential Loan Application*

Role of the transaction agent (TA)

The ability of a buyer or an owner to obtain financing is an integral component of most real estate transactions, whether the intended use of the loan proceeds is for:

- new property acquisitions;
- tenant improvements (TIs) under a lease;
- construction of buildings; or
- personal-use.

Sources of conventional financing

When applying for a **conventional loan**, a buyer has several sources of lenders to choose from, including:

- banks, thrifts and credit unions, called *portfolio lenders*;
- insurance companies and trade association pensions, called *institutional lenders*; and
- mortgage bankers who resell the loan in the secondary loan market, called *warehousing lenders*.

While portfolio and institutional lenders typically service their own loans, they often originate loans for immediate sale as do mortgage bankers, called *warehousing*.

Warehoused loans are sold on the **secondary mortgage market** to investment pools, such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae) and Wall Street bankers.

The business of servicing loans is also bought and sold, causing the loan to appear to be changing hands.

Lenders who originate loans for sale in the **secondary market**, called *Real Estate Settlement Procedures Act* (*RESPA) lenders*, evaluate a buyer's borrowing potential based on the ever changing credit and income requirements and property standards set by the secondary market agency or investment pool seeking to buy newly originated loans.

The submission of a *loan application* to a private or institutional lender is the catalyst which sets the machinery of the mortgage industry in motion.

All too often, a buyer needing purchase-assist funding is left to grapple single-handedly with the lender to look out for his own financial interests with no guidance or protective assistance. It is the duty of the **gatekeeper** who brought the buyer into the marketplace, the buyer's agent, called by lenders a *transaction agent* (TA), to diligently ensure his buyer negotiates the best financial advantage available to him for the class of loan the buyer seeks.

The TA neither **arranges** nor **makes** a loan. His principal task is to focus on negotiating the real estate transaction, usually between a buyer and seller, but a builder may be involved. However, for the sales transaction to close, and for the TA to get his fee, a loan needs to be arranged with a lender to provide supplemental funding for the buyer's payment of the purchase price. The TA's compensation for negotiating the real estate transaction is only fully earned and payable when he has taken all steps necessary to eliminate the loan funding contingency, the ultimate event allowing escrow to close.

This all-encompassing duty imposed on the TA to diligently serve the buyer's best interests includes policing the:

- loan application submission;
- lender's loan packaging process; and
- funding conditions to vigilantly ensure that all the documents escrow needs to comply with the lender's closing instructions are in order so funding can take place.

For the buyer, as with any borrower, the greatest risk of loss of savings and overcommitment of future earnings in a real estate transaction occurs when arranging the loan with the lender's loan representative.

The TA is a paid advisor with a duty owed to the buyer to police all facets of the loan process. This obligation includes eliminating the loan contingency by helping the buyer locate and close on the most advantageous loan terms available in the market. No less could be reasonably expected of an agent.

The TA is the buyer's most reliable and knowledgeable ally in the real estate transaction. This alliance extends beyond the moment the purchase agreement offer is accepted to all critical interactions with the lender who will fund the closing.

The lender is not an agent of the buyer, but his sworn **adversary**. As an outsider to the mortgage lending industry, the unassisted buyer is placed in an inherently submissive position to the lender who will instinctively prey on the buyer's ignorance of the classic loan process to increase its profit. Again, no less could be reasonably expected from a lender.

What must be understood by the TA is that the lender's product – money – is unpriced until closing. This holds true in spite of the *good faith estimate (GFE)* of costs and interest rate disclosures that are given to the buyer within three business days following the lender's receipt of the loan application. [See **first tuesday** Form 204 (DRE 883) and Form 204-5 (HUD-GFE)]

The most competent TA has experience policing lenders and is aware of the methods they use to glean the highest rates, most points and high-profit garbage fees from the unprotected buyer. If the lender's tactics are anticipated by the TA, the TA will counsel the buyer so he is on guard against any form of lender deceit. By doing so, the TA prevents lenders from pulling the wool over the buyer's eyes, as history has proven they are prone to do.

Before meeting with a lender rep

A buyer's first step toward obtaining a loan requires him to submit a standardized Uniform Residential Loan Application to a lender as a **prospective borrower**. [See Figure 1, **first tuesday** Form 202 (FNMA 1003)]

The application itself, designed to be completed by the buyer/borrower with the assistance of the TA and the lender's loan representative, establishes the:

- type of mortgage sought by the buyer/borrower and the terms sought for the loan;

Figure 1

first tuesday *Form 202 (FNMA 1003) - Uniform Residential Loan Application*

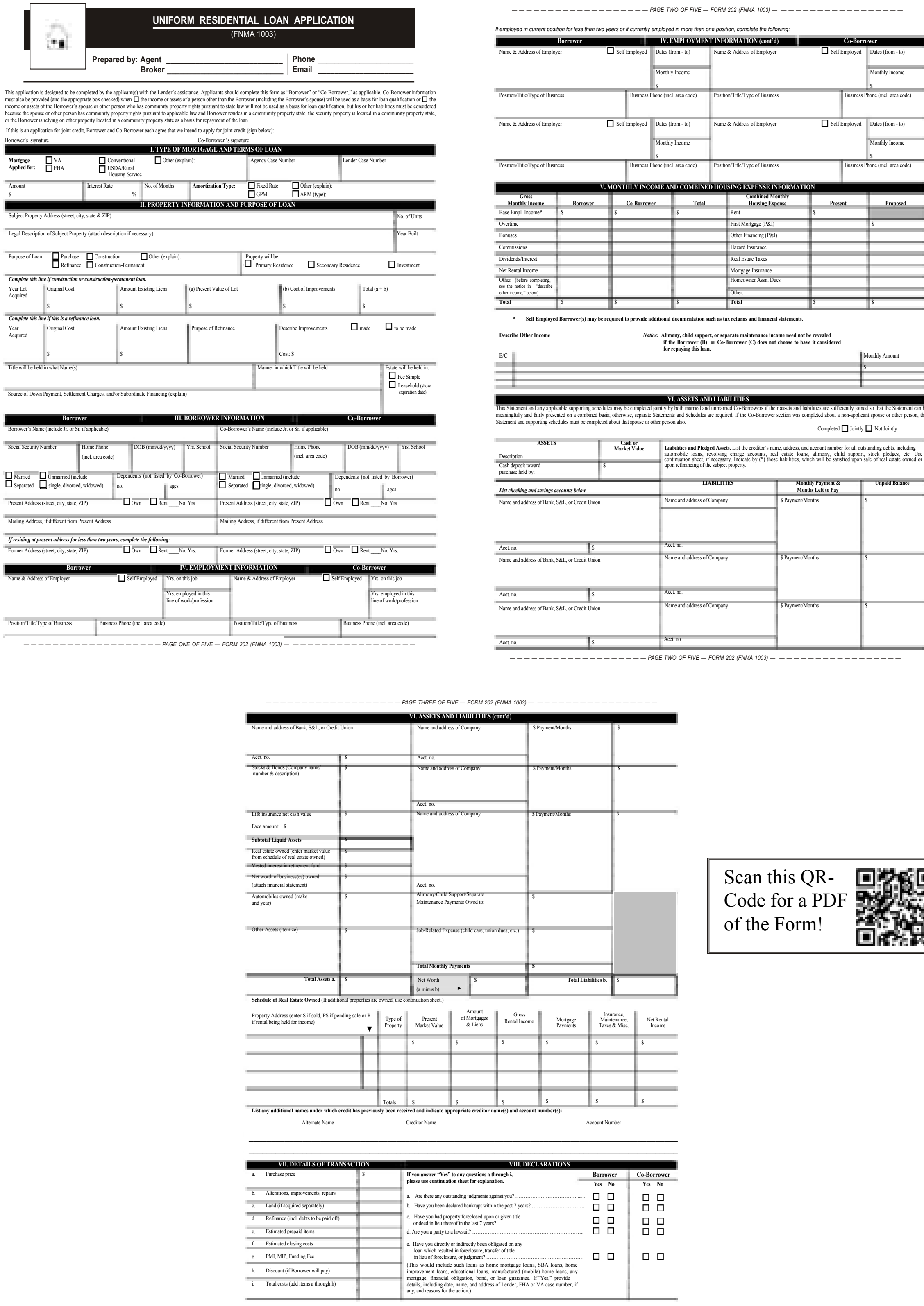

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Figure 1, continued

— PAGE FOUR OF FIVE — FORM 202 (FNMA 1003) —

VII. DETAILS OF TRANSACTION	
j. Subordinate financing	
k. Borrower's closing costs paid by Seller	
l. Other Credits (explain)	
m. Loan amount (exclude PMI, MIP, Funding Fee financed)	
n. PMI, MIP, Funding Fee financed	
o. Loan amount (add m & n)	
p. Cash from/to Borrower (subtract j, k, l & o from i)	

VIII. DECLARATIONS	Borrower Yes	Borrower No	Co-Borrower Yes	Co-Borrower No
If you answer "Yes" to any questions a through i, please use continuation sheet for explanation.				
f. Are you presently delinquent or in default on any Federal debt or any other loan, mortgage, financial obligation, bond, or loan guarantee? .... If "Yes," give details as described in the preceding question.	☐	☐	☐	☐
g. Are you obligated to pay alimony, child support, or separate maintenance?	☐	☐	☐	☐
h. Is any part of the down payment borrowed?	☐	☐	☐	☐
i. Are you a co-maker or endorser on a note?	☐	☐	☐	☐
j. Are you a U.S. citizen?	☐	☐	☐	☐
k. Are you a permanent resident alien?	☐	☐	☐	☐
l. **Do you intend to occupy the property as your primary residence?** .... If "Yes," complete question m below.	☐	☐	☐	☐
m. Have you had an ownership interest in a property in the last three years?	☐	☐	☐	☐
(1) What type of property did you own—principal residence (PR), second home (SH), or investment property (IP)?				
(2) How did you hold title to the home—solely by yourself (S), jointly with your spouse (SP), or jointly with another person (O)?				

IX. ACKNOWLEDGEMENT AND AGREEMENT

Each of the undersigned specifically represents to Lender and to Lender's actual or potential agents, brokers, processors, attorneys, insurers, servicers, successors and assigns and agrees and acknowledges that: (1) the information provided in this application is true and correct as of the date set forth opposite my signature and that any intentional or negligent misrepresentation of this information contained in this application may result in civil liability, including monetary damages, to any person who may suffer any loss due to reliance upon any misrepresentation that I have made on this application, and/or in criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Sec. 1001, et seq.; (2) the loan requested pursuant to this application (the "Loan") will be secured by a mortgage or deed of trust on the property described in this application; (3) the property will not be used for any illegal or prohibited purpose or use; (4) all statements made in this application are made for the purpose of obtaining a residential mortgage loan; (5) the property will be occupied as indicated in this application; (6) the Lender, its servicers, successors or assigns may retain the original and/or an electronic record of this application, whether or not the Loan is approved; (7) the Lender and its agents, brokers, insurers, servicers, successors, and assigns may continuously rely on the information contained in the application, and I am obligated to amend and/or supplement the information provided in this application if any of the material facts that I have represented herein should change prior to closing of the Loan; (8) in the event that my payments on the Loan become delinquent, the Lender, its servicers, successors or assigns may, in addition to any other rights and remedies that it may have relating to such delinquency, report my name and account information to one or more consumer reporting agencies; (9) ownership of the Loan and/or administration of the Loan account may be transferred with such notice as may be required by law; (10) neither Lender nor its agents, brokers, insurers, servicers, successors or assigns has made any representation or warranty, express or implied, to me regarding the property or the condition or value of the property; and (11) my transmission of this application as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or my facsimile transmission of this application containing a facsimile of my signature, shall be as effective, enforceable and valid as if a paper version of this application were delivered containing my original written signature.

Acknowledgement. Each of the undersigned hereby acknowledges that any owner of the Loan, its servicers, successors and assigns, may verify or reverify any information contained in this application or obtain any information or data relating to the Loan, for any legitimate business purpose through any source, including a source named in this application or a consumer reporting agency.

Borrower's Signature	Date	Co-Borrower's Signature	Date
X		X	

X. INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the Federal Government for certain types of loans related to a dwelling in order to monitor the lender's compliance with equal credit opportunity, fair housing and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a lender may not discriminate either on the basis of this information, or on whether you choose to furnish it. If you furnish the information, please provide both ethnicity and race. For race, you may check more than one designation. If you do not furnish ethnicity, race, or sex, under Federal regulations, this lender is required to note the information on the basis of visual observation and surname if you have made this application in person. If you do not wish to furnish the information, please check the box below. (Lender must review the above material to assure that the disclosures satisfy all requirements to which the lender is subject under applicable state law for the particular type of loan applied for.)

BORROWER ☐ I do not wish to furnish this information	CO-BORROWER ☐ I do not wish to furnish this information
Ethnicity: ☐ Hispanic or Latino ☐ Not Hispanic or Latino	**Ethnicity:** ☐ Hispanic or Latino ☐ Not Hispanic or Latino
Race: ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White	**Race:** ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White
Sex: ☐ Female ☐ Male	**Sex:** ☐ Female ☐ Male

To be Completed by Interviewer	Interviewer's Name (print or type)	Name and Address of Interviewer's Employer
This application was taken by:		
☐ Face-to-face interview	Interviewer's Signature — Date	
☐ Mail		
☐ Telephone	Interviewer's Phone Number (incl. area code)	
☐ Internet		

— PAGE FOUR OF FIVE — FORM 202 (FNMA 1003) —

— PAGE FIVE OF FIVE — FORM 202 (FNMA 1003) —

CONTINUATION SHEET/RESIDENTIAL LOAN APPLICATION

Use this continuation sheet if you need more space to complete the Residential Loan Application. Mark **B** for Borrower or **C** for Co-Borrower.	Borrower:	Agency Case Number:
	Co-Borrower:	Lender Case Number:

I/We fully understand that it is a Federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

Borrower's Signature	Date	Co-Borrower's Signature	Date
X		X	

FORM 202 (FNMA 1003) **3-11**

- intended use of the loan funds and the property's information [See **first tuesday** Form 202-2];
- buyer's/borrower's (and co-borrower's) information and employment history;
- monthly income and combined housing (personal) expenses [See **first tuesday** Form 209-2 (FNMA 1020)];
- assets and liabilities [See **first tuesday** Form 209-3];
- details of the transaction and declarations; and
- acknowledgment and signatures.

However, before submitting the application to the lender, the TA needs to inform the buyer about what to expect during the loan application process. By doing so, the buyer is prepared and well-informed to respond defensively during the loan packaging process which is when the financial stakes are at their highest for both the buyer and lender.

Before submitting the application to the lender, the TA needs to inform his buyer of:

- the expectations held and the role of each servicer or affiliate involved in the loan transaction (the lender's loan representative, the lender funding the loan, any mortgage loan broker involved, private mortgage insurance (PMI) carrier, credit agencies, the appraiser, title insurer and escrow company, etc.);
- what is going to take place during the application process (submission of the application, lender disclosures, payment of lender costs, gathering documents, funding requirements, etc.); and
- what to guard against (issues fabricated by lenders to drive up interest rates and fees beyond their initial estimates on unwary buyers without justification prior to closing).

The TA should also assist the buyer in gathering the necessary documents to be submitted in conjunction with the loan application. These documents frequently take the form of W2's and recent pay-stubs to evidence the employment information represented by the buyer in section four of the loan application. [See Figure 1, **first tuesday** Form 202 (FNMA 1003)]

Other portions of the loan application will need to be later verified by the lender with supplemental documents, such as:

- an appraisal report to establish the value of the property serving as security, as called for in section two;
- recent bank statements;

Types of loans

The typical conventional loan for homebuyers is the 30-year mortgage with a **fixed rate** of interest which is based on long-term rates.

The buyer's monthly payment remains the same during the life of the fixed-rate loan since the interest rate remains the same. Fixed-rate loans offer greater long-term stability for the homebuyer than do loans with varying interest rates and payment schedules.

However, the qualified buyer is not restricted to the historical fixed-rate, 30-year mortgage. Other options to consider include:

- adjustable rate mortgages (ARMs) where the interest rate changes periodically based on an index for short-term loans, plus a margin, limited by interest rate and payment caps and floors, which cause the buyer's monthly payment to adjust to continue the loan amortization [See Chapter 56];
- rate buy-downs where the buyer receives an initial interest rate which is periodically increased, with the monthly payment adjusted accordingly, to a fixed rate within a few years, called a *graduated payment loan* (GPM);
- the length of the loan, typically loan terms are 15 or 30 years, although some lenders offer 20-, 25- or 40-year loans based on amortization;
- assumable loans allowing resale to a creditworthy buyer, with or without a rate adjustment;
- bi-weekly mortgagees with payments made every two weeks to reduce the total amount of interest paid on the loan;
- private mortgage insurance (PMI) where a qualifying buyer can obtain a loan with less than a 20% down payment while paying a premium for insurance to cover the lender's risk of loss created by the smaller down payment. [See Chapter 67]; and
- *Interest Only PLUS* (IOP) 35 year program in which only interest is paid for the first five years of the loan, then a set fixed rate of interest is paid for the remaining 30 years.

- verification of deposit or tax returns to establish the buyer's assets, as called for in section six; and
- a credit report to establish the buyer's liabilities and propensity to repay the loan, also called for in section six. [See Figure 1, **first tuesday** Form 202 (FNMA 1003)]

The necessity of separate applications to multiple lenders

When a loan contingency exists in a transaction, which is almost always the case in sales of real estate, the buyer will need assistance when negotiating with the lender to ensure he will end up with the most competitive loan rates and terms available.

To best achieve this advantage, the TA needs to advise the buyer to consider submitting separate loan applications to multiple lenders, a minimum of two.

This is no different than getting a bid on the purchase price of the same automobile from two car dealers, except that substantially more money (and savings) is involved.

By submitting applications to at least two lenders, the buyer is armed with a fail-safe system to bypass unscrupulous changes by the lender, their representatives, or any mortgage loan brokers involved.

If one lender's costs and rates **change unreasonably** at the time of closing, the buyer has another loan application in process with a different competing lender.

Multiple applications keep the lenders vying for the borrower's business. It is competition which assures they remain competitive to the last minute – the moment of funding.

Lenders, of course, do not like to be competitive, much less controlled by antitrust laws.

For this reason they instinctively advise buyers not to submit multiple applications for credit, fabricating the claim that additional applications will interfere with debt ratio analysis during loan processing. Lender representatives have gotten good at this.

However, a buyer who submits applications to two lenders has a bargaining chip against a lender who later:

- loads on the garbage fees at the time of closing; or
- is unable or unwilling to originate the loan on the terms initially represented by it, or at the lower prevailing par rate available in the loan market at the time of closing.

The submission of a loan application to a lender, much less multiple lenders, does not commit the buyer to any obligation to any lender. A lender may only disclose reasonable and competitive estimates and loan terms before and at the time the initial loan application is submitted in order to lure the buyer to stay with them during the loan packaging process. However, the lender has no obligation not to boost its costs, fees or the interest rate at any later stage in the process, usually reserved to a change just three days before closing.

Within three business days after submitting the loan application to the lender, the lender must hand the buyer the lender's GFE of costs. On this form, the lender discloses all loan related charges to be paid by the buyer, such as origination fees, credit report fees, insurance costs, and prepaid interest it intends to charge or be reimbursed for originating the loan. [See **first tuesday** Forms 204 (DRE 883) and 204-5 (HUD-GFE)]

If the estimate of costs and rates worked up by the loan representative prior to submission of the loan application are widely divergent from those furnished in the GFE and accompanying *Truth-in-Lending Act (TILA)* annual percentage rate (APR) disclosures, the lender's true performance colors are instantly exposed. [See Figure 2, **first tuesday** Form 221 and **first tuesday** Form 204-1 (DRE 883)]

Alternatives to conventional loans

Aside from conventional loans which are available to borrowers with a sufficient down payment and a good credit standing, the agent assisting the buyer to obtain a loan should expose the buyer to other types of available financing, including:

- loans insured by the Federal Housing Administration (FHA) which are available to borrowers with a small down payment and less than perfect credit rating [See Chapter 66];
- loans insured by the Veterans Administration (VA) which are available to military veterans; and
- Cal-Vet loans which are available to military veterans living in California.

Each type of loan has unique advantages and disadvantages.

The agent's ability to explain the different qualification requirements for each alternative type of financing helps the buyer make informed choices from among the lenders and loans available to satisfy the loan contingency and close the purchase without being misled.

The buyer, with the proper guidance of the TA, can help determine at the time of the disclosures whether the loan representative gave them straightforward and honest information, or if the initial interview with the loan representative was a fabrication to entice the buyer to apply for a loan with them.

To compound this deception, lenders often change their rates and charges immediately prior to closing. When they do so, they hand the borrower a second "refreshed" GFE and TILA (APR) disclosure with modified (more specifically, *increased*) charges and loan terms, presented to be signed at least three business days before closing. [See Figure 2, **first tuesday** Form 221 and **first tuesday** Form 204-1 (DRE 883)]

If the buyer has not submitted a backup application with another lender, the borrower has no alternative available to protect himself against the lender going in for extra profits at the last possible opportunity. However, by keeping loan applications in the works with two or more lenders and holding negotiations to establish which lender ultimately offers the best terms and rates, the TA is able to direct the buyer to the lender who offers the superior set of loan costs, terms for payment and interest rates. No less is expected by a buyer of his agent.

Although the second application doubles the buyer's application costs, these costs are de minimis in comparison to the total dollar amounts involved in the transaction. The TA should not let the borrower be dissuaded on these grounds.

Multiple government agencies, both federal and state, promote the practice of submitting multiple applications. To assist the buyer with the task of comparing the products of two or more lenders after multiple applications have been submitted, entities such as the California Department of Corporations, Freddie Mac, the Federal Reserve, and the Federal Trade Commission publish *Mortgage Shopping Worksheets*.

These worksheets, designed to be completed by the buyer with the assistance of the TA, contain two columnar itemizations of all the variables commonly occurring at the time of origination and over the life of a loan.

After submitting loan applications to two lenders and receiving the corresponding GFE and TILA (APR) disclosures, the buyer will possess all the information needed to fill in both columns, one for each lender. Once complete, the buyer and TA can clearly compare the terms offered by the competing lenders and proceed to close on the more advantageous offer. The California Department of Corporation's Mortgage Shopping Worksheet can be obtained through their website at *www.corp.ca.gov*.

Fundamentals of the Uniform Residential Loan Application

The *Uniform Residential Loan Application* prepared by the buyer, with the professional assistance of his TA, supplies the lender with necessary information about the buyer and the property securing the loan. It also gives the lender authorization to start the loan packaging process, activity necessary for the lender to determine whether the buyer is qualified to obtain a mortgage, and if so, on what terms. [See Figure 1, **first tuesday** Form 202 (FNMA 1003)]

Generally, the loan would be sought in a sales transaction by a buyer who requires the money to fund the purchase of a property. However, the loan may also be used by an owner of vacant land to construct a dwelling, or used by a property owner to improve or renovate a property he currently owns, or to refinance an existing mortgage. In some instances, the loan could be sought by a tenant on a long-term lease who has agreed to make **tenant improvements** (TIs) to the property he rents.

As can be inferred by its title, the Uniform Residential Loan Application is intended primarily for use on residential property loans, such as one-to-four unit residential property, condominiums (attached or detached), or rental property of any size which is exclusively residential.

However, as a generic loan application, it can be used to apply for a loan secured by any type of property since it contains all the information required for arranging all types of real estate loans. In practice, the type of property intended to be purchased by the loan proceeds is clear based on the description of the property in the loan application.

Components of the Uniform Residential Loan Application

Once the TA has reviewed the loan process with the buyer, now called the **borrower**, the application must be completed and submitted. The application itself is designed to be completed with the loan representative, though it is crucial that the TA also be present during this critical step of the transaction.

The first section of the Uniform Residential Loan Application calls for the borrower, with the assistance of the loan representative, to enter the **type of mortgage sought**, such as conventional, VA or FHA-insured. The borrower must also indicate the total amount of the loan requested, the anticipated interest rate (fixed or adjustable), the periodic payment schedule (constant or graduated), as well as the amortization period (positive or negative).

Figure 2

first tuesday *Form 221-*

Truth-in-Lending Disclosure - For Personal-Use Loans Secured by One-to-Four Residential Units

Scan this QR-Code for a PDF of the Form!

TRUTH-IN-LENDING DISCLOSURE

For Personal-Use Loans Secured by Real Estate

Prepared by: Agent____________________ **Phone**______________________________
Broker____________________ **Email**______________________________

NOTE: This financing disclosure is mandated for use by lenders originating real estate secured loans when the loan proceeds are used primarily to purchase real estate or personal property for personal, family or household use and the lender made more than five personal-use loans in the previous calendar year or this year.

A separate good faith estimate of settlement costs must be made prior to or concurrent with this disclosure. [See **ft** Form 204]

The signing of the loan agreement by the Borrower may take place no sooner than the seventh day after the disclosures are delivered.

DATE: ____________, 20______, at ____, California.

Prepared by ____

Address ____

Phone ____________________________________ Email ____________________________

Items left blank or unchecked are not applicable.

FACTS:

Lender identification ____

Borrower identification ____

Loan Broker identification ____

Account or application number ____

ANNUAL PERCENTAGE RATE	FINANCE CHARGE (see §3.3)	AMOUNT FINANCED (see §2.3)	TOTAL OF PAYMENTS (see §4.1)
The annual percentage rate of the charges on this financing is	The total dollar amount of the financing charges over the life of this financing is	The amount of funds or credit disbursed to you or on your behalf is	The amount you will have paid if you make all payments as scheduled is
______%	$0.00	$0.00	$______________

1. **LOAN AMOUNT:**
   The **principal amount** of this personal-use loan is the amount of . . . . $______________
2. **AMOUNT FINANCED:**
   2.1 Advances by the lender in addition to the principal amount of the loan . . . . (+)$______________
   2.2 Prepaid finance charges received by Lender (see good faith estimate for origination fee, discount and prepaid interest) . . . . (-)$______________
   2.3 Total amount financed (lines 1 and 2.1 less 2.2) . . . . (=)$ 0.00
3. **FINANCE CHARGES:**
   3.1 Interest payments scheduled (line 5.1 less line 1) $0.00
   3.2 Prepaid finance charges received by Lender (line 2.2) . . . . (-)$______________
   3.3 TOTAL finance charges (line 3.1 less 3.2) . . . . (=)$ 0.00
4. **INTEREST RATE:**
   The type of interest rate featured in the loan is:
   4.1 ☐ a fixed rate of interest for the life of the loan.
   4.2 ☐ an adjustable rate of interest which will vary during the life of the loan as disclosed in a separate statement.
5. **PAYMENTS:**
   5.1 Total dollar amount of all scheduled payments $______________.
   5.2 Principal and interest is payable in a total of ____________ installments, each in the amount of $______________, on the ____________ day of every ☐ month ☐ quarter ☐ year, beginning on the ____________ day of ____________, 20______, and continuing until the ____________ day of ____________, 20______, when the principal is due and payable.

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   5.3 A final/balloon payment of $______________ is due on ____________, 20______.
   5.4 A late charge of $______________, or ______% of the delinquent principal and interest will be charged after a ______ day grace period.
   5.5 If you pay off this financing early,
      a. You ☐ have, or ☐ have not, agreed to pay a penalty.
      b. You ☐ have, or ☐ do not have, the right to a rebate of finance charges.
   5.6 This loan ☐ does, or ☐ does not, include a call feature allowing Lender to call the loan except on a default in payments or trust deed lien provisions.
6. **REAL ESTATE SECURITY INTEREST:**
   The loan will be secured by a trust deed lien in favor of Lender on Borrower's:
   6.1 ☐ principal residence, or ☐ other real estate;
   6.2 ☐ owned, or ☐ to be acquired, by Borrower;
   6.3 located at ____.
   6.4 Property damage and liability insurance to be purchased by Borrower.
      a. If purchased through Broker or Lender, the cost appears on the separate good faith estimate settlement costs.
      b. Borrower may choose the insurer.
   6.5 See the Lender's financing documents, note and trust deed for any additional information about nonpayment, default, prepayment rebates and penalties, security interests and loan assumption policy.
   6.6 **Loan Assumption:** If this financing is used to purchase real estate described in §6.3, a subsequent buyer of the real estate:
      a. ☐ may assume the loan on its original terms subject to a creditworthiness clearance and an assumption fee.
      b. ☐ may assume the loan subject to modification of its loan terms, creditworthiness and an assumption fee.
      c. ☐ may not assume the loan.
7. **INSURANCE:**
   Credit life and disability insurance are not required to obtain this financing.
8. **NOTICE TO BORROWER:**
   You are not required to complete this agreement merely because you have received these disclosures or signed a loan application.

Borrower acknowledges receipt of a copy of this disclosure statement.

Date: ____________, 20______

Borrower's Signature: ____

Borrower's Signature: ____

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In the second section, the borrower identifies the property which will be used to secure the loan, as well as the purpose of the loan, such as purchase-assist, refinance, or personal-use equity loan, and the intended use of the property, be it as a primary residence or for investment purposes. The source of down payment funds and closing costs are also to be entered here.

Information relating to the borrower, such as his **name** and **social security number**, is entered in section three. Here, and in section four, space is left to insert any co-borrower information if the liabilities, income or assets of the co-borrower will be considered for loan qualification purposes. If the liabilities, income or assets of a co-borrower are community property, the borrower is also to mark the appropriate community property box at the top of the form.

California is a *community property* state, meaning most assets and liabilities incurred during the marriage are shared between husband and wife, including real estate interests. If community property is not involved in the transaction for which the borrower is applying for a loan, then the spouse is not a co-borrower and that spouse's separate assets cannot be seized by the lender.

If the assets and liabilities are to be considered **community property** (as is generally the case with home purchases by a husband and wife), then the *borrower* is one spouse and the *co-borrower* is the other spouse.

However, a separate application regarding assets and liabilities must be filled out by the co-bo rower and separately submitted to the lender if:

- the assets and liabilities result from separate property owned by a co-borrower;
- the co-borrower is a necessary party to the transaction as the separate property encumbered will be considered community property; or
- the co-borrower is a co-signer of the note as a primary borrower.

The borrower and co-borrower will prepare the Balance Sheet Financial Statement – Assets, Liabilities and Net Worth, **first tuesday** Form 209-3, if their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower is to prepare their separate loan application for individual consideration by the lender.

The borrower may later complete the Statement of Information – For General Index, **first tuesday** Form 401-4, to disclose confidential information to be used by the title company to search the general index (GI) for information on the borrower and any co-borrower regarding judgments and other legal difficulties which might interfere with their taking title or providing the security interest in the property required by the lender.

Section four of the Uniform Residential Loan Application calls for the borrower's (and co-borrower's) **employment information** to determine his source of income. Space is provided for the entry of the position currently held by the borrower, his title, and years spent at that specific job and within that profession. The borrower is to mark the checkbox to indicate if he is self-employed. Lenders use this information to determine the financial stability of the borrower, as well as his ability to repay his debts.

Next, in section five, the borrower is to report his **monthly income** and **combined housing expenses**. A self-employed borrower should submit a profit and loss statement or have a printout of one from his company if it is a major source of his income.

The borrower's **assets** and **liabilities** are entered into section six which establishes his net worth. The lender desires detailed information about the borrower's assets and is entitled to know all of the borrower's liabilities as they affect his ability to repay the loan. However, the borrower may not want to disclose all his assets. Thus, a balance must be struck between maintaining financial privacy and disclosing enough assets (though all liabilities) to the lender to get creditworthiness clearance so the loan will be funded.

In section seven, spanning pages five and six, the borrower is to enter **details about the transaction** the loan will be funding. Items called for include the purchase price of the property if the loan is purchase assist. The price entered should be the net of any rebates or discounts or other allowances received by the borrower whether directly or indirectly, or from the seller or the brokers involved.

Also called for in section seven is the cost of repairs, alterations, or improvements made to the property. If the loan is to be used for a **refinance**, the estimated cost would be entered here at section "d", leaving "a", "b", and "c" blank.

Next, in section eight, the borrower (and any co-borrower) makes a declaration of any relevant **miscellaneous creditworthiness issues** which need to be disclosed to the lender, such as debt enforcement or debt avoidance they have experienced.

The ninth section is **signed by the borrower** (and any co-borrower) to acknowledge and agree to the following conditions:

- the information provided by the borrower (and any co-borrower) is true and accurate, and if it is not, informs the borrower of the penalties of misrepresentation;
- a trust deed lien will be recorded on the property described in the application to secure the loan;
- the property will not be used for any illegal purposes;
- the purpose of the application is to induce the lender to lend funds to the borrower;
- the property will be occupied as represented in the application;
- the lender will retain the application whether or not it decides to fund the loan;
- the borrower will amend the application and resubmit it to the lender if the facts originally stated substantially change;

- if the borrower defaults on the loan, the default will be reported to one or more credit reporting agencies;

- the borrower may assign the loan to others, though the borrower will not be able to sell the property subject to the same rights as the lender to assign its position;

- the lender or any of its affiliates has made no representations about the value of the property which will secure the loan if funded;

- an emailed or faxed version of the loan application is equally valid as the printed copy of the form; and

- the lender is authorized to verify all aspects of the loan application as represented by the borrower.

The bottom of the loan application, section ten, contains a non-mandatory portion specifying the borrower's **ethnicity, race and gender**. This portion of the loan application is used by the federal government to monitor the lender involved and ensure its compliance with fair housing, equal credit opportunity, and home mortgage disclosure laws.

The bottom of section ten is to be completed by the loan representative who assisted the borrower to complete the application. The loan representative is to indicate how the application was taken, whether in a face-to-face interview with the borrower, through the mail, over the phone, or via the internet.

Self-employed buyer exposed

The buyer is to mark the checkbox in section four to indicate if he is self-employed. A self-employed buyer is typically required to provide a lender with:

- a signed Internal Revenue Service (IRS) Form 4506 (Request for Copy of Tax Form) [See **first tuesday** Form 215] ;

- copies of the buyer's income tax returns for at least the past two years; and

- copies of his financial statements. [See **first tuesday** Forms 209-2 and 209-3]

RESPA and TILA disclosures

The *Real Estate Settlement Procedures Act (RESPA)* mandates lenders active in the secondary mortgage market must disclose all loan related charges on loans used to purchase one-to-four unit residential properties, such as origination fees, credit report fees, insurance costs and prepaid interest.

On adjustable rate mortgages (ARMs), the lender must inform the buyer not only of the interest rate, but also the index, margin and payment and interest rate caps. [See **first tuesday** Form 320]

The RESPA lender must provide the buyer with the following:

- a GFE of all loan related charges listed in Section L of the HUD-1 statement within three days after the lender's receipt of the borrower's loan application [24 Code of Federal Regulations §3500.7; see **first tuesday** Form 204-1 (DRE 883)];

- a copy of the HUD-published special information booklet, titled Buying Your Home – Settlement Costs and Helpful Information, within three days after the lender's receipt of the borrower's application [24 CFR §3500.6]; and

- a HUD-1 or HUD-1A closing statement detailing all charges. [24 CFR §3500.10(b); see **first tuesday** Form 402]

If the buyer is arranging financing through a mortgage loan broker, the broker, not the lender, must provide a copy of the special information booklet to the buyer. [24 CFR §3500.6(a)(1)]

However, the booklet does not need to be given to the buyer if the loan funds for are for:

- the refinance of an existing mortgage;

- a closed-end loan in which the lender takes a subordinate lien;

- a reverse mortgage; and

- any federally related loan that will not be used for the purchase of a one-to-four unit residential property. [24 CFR §3500.6(a)(3)]

Federal TILA disclosures, given to the buyer along with the GFE by the lender within three business days of receipt of the buyer's loan application, are designed to give the buyer standardized loan information for easy comparison of terms between loans offered by different lenders. [See Figure 2, **first tuesday** Form 221]

Reg Z implements the TILA disclosures required on federally defined consumer financing. Consumer financing, also called Reg Z financing or, more clearly, personal-use financing, arises out of:

- real estate loans, their assumptions or refinance;

- personal property loans; and

- carryback financing by dealers.

Situations requiring Reg Z disclosures by the lender to the buyer include:

1. Purchase-assist loans for buyers to acquire property:

    1.1 One-or two-unit residential properties to be occupied by the buyer as his principal residence. [12 Code of Federal Regulations §226.3(a)(4)]

    1.2 A vacation home or second home which will be occupied by the buyer more than 14 days during the coming year. [12 CFR §226.3(a)(3)]

    1.3 Recreational land to be acquired for the personal use of the buyer. [12 CFR §226.3(a)(3)]

Editor's note – No Reg Z disclosures are required for business, investment, or agricultural acquisitions or for purchase-assist loans for three or more residential units whether or not the borrower occupies. [12 CFR §226.3(a)(4)]

2. Further encumbrance (equity) loans on any type of property already owned by the buyer:

    2.1 Loans funding personal, family, or household uses secured by any type of property. [12 CFR §226.2(a)(12)]

    2.2 Loans funding the maintenance and repair of a one-to-four unit residential property owned and occupied by the buyer. [12 CFR §226.3(a)(4)]

    2.3 Net proceeds from the loan are for deposit into the buyer's personal account. [12 CFR §226.3 (a)(2)]

Editor's note – All other equity loans are exempt from Reg Z disclosures.

3. Refinance of an existing loan on any type of property:

    3.1 A new loan funding the payoff of a loan which was originated or assumed by the owner as a personal-use loan subject to Reg Z. [12 CFR §226.20(a)]

Editor's note – No other refinancing requires Reg Z disclosures, even if secured by the principal residence.

When a loan is subject to both RESPA and TILA, the timing for *Regulation Z (Reg Z)* disclosures required by TILA are accelerated and included with the RESPA disclosures. The **Reg Z** disclosures state the terms of the financing and include an itemization of the loan costs incurred by the buyer, including finance charges, interest rates, payment schedules and the APR. [12 CFR §§226.17, 226.18; see Figure 2, **first tuesday** Form 221]

In practice, the RESPA lender originating a personal use mortgage makes the Reg Z disclosures, twice:

- within three days after the lender receives the buyer's loan application; and

Figure 3

first tuesday Form 207-
Authorization to Prepare Appraisal Report - Calif. Bus & PC §11321

AUTHORIZATION TO PREPARE APPRAISAL REPORT
(California Business & Professions Code §11321)

Prepared by: Agent___________________ **Phone**_____________________________
Broker___________________ **Email**_____________________________

DATE: _____________, 20______, Prepared by ____.

TO:	**FROM:**
Appraiser ______________________________	Agent ______________________________
Appraisal Company ________________________	Broker/Lender ________________________
Address ______________________________	Address ______________________________
______________________________________	______________________________________
Phone _______________ Cell _______________	Phone _______________ Cell _______________
Email ______________________________	Email ______________________________

SECTION I:

1. Regarding Broker/Lender loan application number ____
1.1 Borrower's name ____
2. This is your authorization to engage in the development of an evaluation for the property and prepare and deliver to Broker/Lender your appraisal report.
2.1 To assist you in this effort, the following checked reports are known to be available:
a. ☐ comparable properties and subject's amenities at Broker/Lender office.
b. ☐ the property owner's condition of property (TDS) disclosure statement [See **ft** Form 304]
☐ at listing agent's office ____
☐ at Broker/Lender's office ____
c. ☐ home inspector's report on the subject property
☐ at listing agent's office ____
☐ at Buyer's agent's office ____
☐ at Broker/Lender's office ____
3. The type of appraisal requested:
☐ drive by, ☐ full appraisal, or ☐ ____
3.1 The type of appraisal report requested:
☐ desk review, ☐ field review, ☐ value range analysis, or ☐ ____________________________
4. Your contact person you are to call to set up the day and time for your visual inspection of the property is
(Name) ______________________________ (Phone) ______________________________
5. The subject property is located at ____
____
5.1 ☐ SFR, ☐ condo, ☐ two-to-four residential units, ☐ land, ☐ mobilehome, or ☐ __________________
5.2 Owner's/Borrower's name ____
Home Phone _______________ Cell Phone ________________ Work Phone ________________
6. Borrower's purpose for the loan:
☐ purchase-assist funds, ☐ refinance, ☐ equity withdrawal, or ☐ ____________________________
7. Your appraisal report and evaluation will be used in our analysis of the property as security sufficient in value as collateral for the loan applied for and for transmittal to Lender who will fund or purchase the loan. Also, Borrower is entitled to a copy of your appraisal report and evaluation.
8. Your fee for your evaluation and appraisal report will be paid:
☐ on delivery of your report by Broker/Lender on behalf of Borrower.
☐ by the loan escrow company from a Borrower's funds.
☐ ____
____
8.1 It is anticipated the amount of your fee will be $_______________.

— — — — — — — — — — PAGE ONE OF TWO — FORM 207 — — — — — — — — — —
— — — — — — — — — — PAGE TWO OF TWO — FORM 207 — — — — — — — — — —

9. Further instructions: ____
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Submitting Loan Representative's Signature: ____

SECTION II:
FOR USE BY APPRAISER:
10. Please fill in the following and fax or email this form back to Broker/Lender indicated on page one.
10.1 Walk-through of the property is scheduled for:
Date _______________ Time _________________
10.2 Anticipated date of delivery of your appraisal report is _____________, 20______.

FORM 207 03-11

Scan this QR-Code for a PDF of the Form!

Government financing programs at a glance

A variety of state and federal assistance programs exist, offering down payment assistance for low to moderate income buyers and first-time buyers, mortgage refinance or modification programs to distressed owners, and special programs for veterans.

Federal programs:

Federal Housing Administration (FHA) insured loan: The **FHA** enables prospective first-time buyers, primarily renters, to become homeowners by insuring lenders against loss for the full amount of the loan. FHA-insured loans have less demanding cash down payment and *loan-to-value ratio (LTV)* requirements than loans originated by conventional lenders. [See Chapter 66]

www.HUD.com

Veterans Administration (VA) loan guarantee: The **VA** loan guarantee program is specially designed to assist qualified veterans or their surviving spouses buy a home with a zero down payment.

www.benefits.va.gov/homeloans

Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) and *Government National Mortgage Association (Ginnie Mae)*: **Fannie Mae, Freddie Mac** and **Ginnie Mae** are **government-sponsored enterprises (GSEs)** designed to help facilitate home purchases for low to moderate income buyers. Fannie Mae and Freddie Mac do not provide home loans directly, but package and sell pools (tranches) of qualifying single family residence (SFR) loans, known as *conforming loans,* as mortgage-backed bonds (MBBs) to Wall Street on the secondary mortgage market.

Fannie Mae: www.fanniemae.com; 1-800-732-6643

Freddie Mac: www.freddiemac.com; 1-800-373-3343

Ginnie Mae: www.ginniemae.gov; 1-800-234-4662

Home Affordable Modification Program (HAMP): **HAMP** is a federal program designed to induce lenders to modify the loans of distressed homeowners by providing an upfront fee of $1,000 for each modification granted. The modification will take the form of a lowered interest rate or extended amortization period, with the goal of reducing the homeowner's housing expense to no more than 31% of his gross income.

Home Affordable Refinance Program (HARP): **HARP** provides federal funds to help homeowners refinance existing mortgages that are backed by Fannie Mae and Freddie Mac. On its initial launch, only those who were current on their payments and whose mortgages did not exceed an LTV of 125% were eligible for a HARP refinance. However, the 125% ceiling was lifted in the first quarter of 2012, provided the homeowner refinances though the same lender who originated the loan.

Home Affordable Foreclosure Alternatives (HAFA): **HAFA** provides incentives for distressed homeowners, lenders and agents to consider a *short sale* or *deed-in-lieu of foreclosure* rather than a foreclosure. It also provides up to $3,000 to the homeowner for moving expenses.

HAMP / HARP / HAFA: www.makinghomeaffordable.gov

State programs:

California Housing Finance Agency (CalHFA): **CalHFA** administers several first-time homebuyer assistance programs, offering 30-year fixed rate mortgages with interest rates and fees typically lower than conventional financing.

www.calhfa.ca.gov; 1-877-922-5432

Department of Veterans Affairs (CalVet): **CalVet** provides a veteran with a mortgage interest rate which is generally below market, low monthly payments and flexible credit standards, as compared to conventional financing, or loans insured by the Federal Housing Administration (FHA) or Veterans Administration (VA). [See Chapter 66]

www.cdva.ca.gov; 1-800-952-5626

Department of Housing and Community Development (HCD): **HCD** programs fund local public agencies and private nonprofit or for-profit entities which produce affordable housing for rental or ownership.

www.hcd.ca.gov/fa; 916-322-1560

- before the buyer signs the loan documents.

The terms of these two disclosures tend to vary from one to another, with the pre-closing disclosure typically containing higher costs and rates than those stated in the lender's original Reg Z disclosure. This inconsistency is the reason a prudent TA should advise his buyer to submit multiple loan applications.

Property appraisal

Once a lender receives a loan application and any processing fee, the property is appraised by a representative of the lender to determine if the property qualifies for a loan. [See Figure 3, **first tuesday** Form 207]

The appraisal determines whether the property is of sufficient value to support the amount of financing the buyer requests, principally, whether the *loan-to-value (LTV) ratio* meets the lender's standards.

Generally, an acceptable LTV for conventional loans is 80% of the property's value, requiring the buyer to make a minimum 20% down payment. A greater LTV compels the prudent lender to require the buyer to obtain PMI.

The lender may reject the loan application by approving a loan of a lower amount if the property value is not adequate to secure the loan amount sought, even if the buyer is qualified to borrow the amount requested. The value limitation is used to limit loan amounts during downturns in the market value of real estate, rather than during a rapidly rising market (as it should). Thus, swings in values throughout an economic cycle are exacerbated by the conduct of lenders.

The loan application package

Once a lender approves property based on an appraisal, a loan package is assembled and sent to a loan committee or underwriting officer for review.

The loan package prepared by the lender includes:

- the loan application [See **first tuesday** Form 209-2 (FNMA 1020)];
- the property appraisal report [See **first tuesday** Form 200];
- a credit report on the buyer;
- the lender's verifications of the information provided on the loan application [See **first tuesday** Forms 210, 210-1, 209, 210, 210-1, 212, 215, and 215-1];
- the purchase agreement, escrow instructions and condition of property disclosure statement handed to the buyer by the seller and broker [See **first tuesday** Forms 150 and 304]; and
- other documentation needed to support the buyer's request, including operation balance sheets, tax returns, IRS Form 4506, title reports and bank statements.

Post-submission: TA duties still exist

Even after the loan application has been submitted to the lender, the TA's duty to the buyer to continue to oversee the functioning of the lender has not been extinguished.

To program his continued engagement in the transaction, the TA uses the Tracking the Loan Origination Process, **first tuesday** Form 339, to set a schedule with the loan representative for when the loan processing activities are to occur. This form provides the TA with a clear picture of what events are to take place and when, and if they are not timely handled by the lender, provides the TA with the opportunity to get on the phone and remedy the failure and get the process back on track. [See **first tuesday** Form 339]

After submission of the loan application, it is the TA's obligation to police the lender, follow up on his inquiries to the lender's loan representative, and get weekly updates to keep the underlying transaction on schedule for closing. Since closing the sales transaction is contingent on obtaining a loan, the TA does not want the buyer he represents to lose the deal, and in turn cause the TA to lose his fee, due to any lender inadequacies.

Progress reports from the lender to the TA must be agreed to with the loan representative. This will likely require the buyer to give authority to the lender to discuss the loan handling with the TA. Though the lender will likely resist any attempt to allow oversight of its actions, the buyer's interests are best served by the TA's **continued oversight** of the time set for completion of each stage of the loan packaging process to ensure delays are avoided.

The TA has a duty of care owed to his buyer to protect against known foreseeable harm and loss of money in the form of extra interest and charges taken by the lender.

"Willing and able" to pay

A loan committee or underwriting officer evaluating a loan package considers a buyer's **capacity** and desire to pay. On the loan application, the buyer provides information regarding personal and housing expenses, both current and estimated, and details of the real estate purchase and loan costs.

Generally, the debt-to-income standard for conventional loans, also called the debt-to-income ratio, limits the buyer's:

- monthly payments for the maximum purchase-assist loan, including impounds for hazard insurance premiums and property taxes, to approximately 31% of the buyer's monthly gross income; and

- long-term debt, plus the monthly payments, to approximately 41% of the buyer's gross monthly income. [See **first tuesday** Forms 229-1, 229-2 and 230]

Lenders use debt-to-income ratios to evaluate the buyer's ability to make timely loan payments, called *buyer capacity*. Lenders may approve a higher debt-to-income ratio if a large down payment is made, or the buyer has valuable assets and carries little debt — and when competition between lenders to originate purchase-assist loans intensifies. [See **first tuesday** Form 230]

The buyer's willingness to make his loan payment is evidenced by the credit report. The credit history demonstrates to the lender whether or not the buyer has a propensity to pay, called creditworthiness.

The debt-to-income ratios can be adjusted depending on one or more compensating factors, such as if the buyer has:

- ample cash reserves;

- a low LTV ratio; and

- spent more than five years at the same place of employment.

The buyer's agent should press the lender to his client's advantage if these compensating factors exist.

Loan approval

A loan approval issued by a lender is often conditioned on a buyer providing more necessary information, for example:

- the property's condition may need correction;
- title may need clearing of defects;
- the buyer may be asked to explain or eliminate derogatories on his credit report; or
- the buyer's long- or short-term debt must be reduced.

To obtain final approval and funding, the buyer must correct any problems to the lender's satisfaction.

Once loan conditions are met and verified, the loan is classified as approved. Escrow calls for loan documents and funds, and on funding, the sales transaction is closed.

Agents must constantly remind themselves that what one lender will not accept as a risk presented by the buyer or the property, another will evaluate and set interest rates according to the risk present by the loan requested by the buyer.

More often than not, a lender exists who will make a loan of some amount and under some conditions to nearly any buyer. It is the business of lenders to do so.

Chapter 65 — A lender's loan commitment

This chapter analyzes a borrower's reliance on a lender's oral commitment to fund a loan.

For a further discussion of this topic, see Chapter 37 of Real Estate Finance.

Chapter 65 Outline

No responsibility for oral or conditional promises

Chapter 65 Terms

Conditional commitment	*Regulation Z*
Loan commitment	*Truth-in-Lending Act*

No responsibility for oral or conditional promises

An owner of industrial land and a manufacturing business he operates on his property applies for a loan from an institutional lender to upgrade and expand his production facilities, and construct additional improvements on the property. The owner has a long-standing business relationship with the lender, having borrowed from them several times over the years.

The lender's loan officer, after processing the loan application, **orally assures** the owner they will provide the long-term financing he will need, called a *take out loan*, to pay off short-term interim financing he will obtain to fund the purchase of equipment and cost of construction.

Relying on the lender's oral assurances, the owner enters into a series of short-term loans and credit arrangements with other lenders and suppliers, and begins the planned improvements.

The loan officer visits the owner's plant during the construction and placement of equipment. The officer comments favorably on the work in progress and again assures the owner the lender will provide the long-term financing sought by the owner.

When completed, the owner makes a demand on the lender to fund the permanent financing. The lender refuses, informing the owner the business no longer has the value needed to justify the long-term financing since operating costs and a business recession have decreased the value of the owner's facilities.

The owner is unable to obtain refinancing elsewhere, and the business and real estate is lost on default in the short-term financing. The owner seeks to recover his money losses from the lender, claiming the lender breached its commitment to provide financing.

Can the owner recover damages from the lender?

No! The lender never entered into an enforceable **loan commitment**. Nothing was placed in writing or signed by the lender which **unconditionally committed** the lender to the specific terms of a loan.

Even though the lender orally assured the owner a loan would be funded, and despite the owner's reliance on his pre-existing business relationship with the lender to fund his expansion, the owner was not justified in relying on the lender's oral commitment to fund a loan. [**Kruse** v. **Bank of America** (1988) 202 CA3d 38]

Lenders rarely make written loan commitments. When lenders do, they are limited to federally mandated nonbinding disclosures on single family residence (SFR) loans under *Regulation Z*, also known as the *Truth-in-Lending Act (TILA)*.

Lenders customarily process applications and prepare loan documents, but they are only signed by the borrower. The lender orally advises the borrower whether the loan has been approved, but signs nothing that binds them. The first and only act committing the lender is its actual funding of the loan — at the time of closing.

Thus, until the lender literally delivers funds and a closing has occurred, the lender can back out of its oral commitment at any time, without liability.

As a result, the balance of power is entirely with the lenders. Thus, mortgage borrowers are forced to rely on unenforceable oral promises when making financial decisions in real estate transactions.

When a lender breaches its oral commitment to lend, the borrower's reliance on anything less than an **unconditional written loan commitment** is not legally justified — even though the borrower had no realistic choice other than to rely on the lender's oral promises.

As a result, prudent borrowers and their agents submit loan applications to more than one lender to guard against these sorts of last-minute surprises.

Chapter 66 The FHA-insured home loan

This chapter presents the single family mortgage insurance program administered by the Department of Housing and Urban Development (HUD) and the Federal Housing Administration (FHA).

For a further discussion of this topic, see Chapter 39 of Real Estate Finance.

Chapter 66 Outline

Enabling renters to become homeowners
One-to-four unit mortgage default insurance
FHA loan limits by area
Loan-to-value (LTV) ceilings
Credit approval
RESPA and TILA disclosures
Personal liability
Buyer liability on a default

Chapter 66 Terms

Compensating factors	*Loan-to-value ratio*
Federal Housing Administratio	*Private mortgage insurance*
Good Faith Estimate	*Purchase-assist loan*
Gross effective income	*Section 203(b)*

Enabling renters to become homeowners

A tenant in an apartment housing complex is solicited by a real estate broker to buy a home. The financial future and tax benefits of home ownership are reviewed with the tenant and compared to the corresponding benefits of rental payments currently paid for shelter by the tenant.

As a result, the tenant indicates he is willing to look into the purchase of a home, but has not accumulated enough cash reserves for the down payment needed to qualify for a purchase-assist loan from a conventional lender, with or without *private mortgage insurance (PMI)*.

However, the broker assures the tenant that first-time homebuyers with little cash available for a down payment can buy a home by qualifying for a *purchase-assist loan* insured by the **Federal Housing Administration (FHA)**.

By insuring loans made with less demanding cash down payment requirements than loans originated by conventional lenders, and with high loan-to-value ratios (LTV), the FHA enables prospective buyers, primarily **renters**, to become homeowners.

One-to-four unit mortgage default insurance

The most commonly used FHA insurance program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, Section 203(b).

The purpose of Section 203(b) is to **enable renters to become homeowners** by allowing for a smaller down payment than required for conventional loans from portfolio lenders.

Loan documentation

The following list of documents may be submitted to an FHA–approved Direct Endorsement lender when applying for a loan:

- Uniform Residential Loan Application signed and dated by all buyers and the lender [See **first tuesday** Form 202 (HUD Form 1003)];
- Buyer's Notification and Interest Rate Disclosure Statement signed by both the buyer and the lender [Form HUD-92900-B];
- Credit Analysis Worksheet – LTV and Income Ratios [See **first tuesday** Form 230];
- picture identification and social security number of each buyer;
- Residential Mortgage Credit Report for each buyer;
- verification of employment and most recent pay stub [See **first tuesday** Forms 210 and 210-1];
- verification of deposit and most recent bank statement [See **first tuesday** Form 211];
- federal income tax returns (individual and business) for the past two years for self-employed borrowers [See **first tuesday** Forms 215 and 215-1];
- sales contract containing an amendatory clause, any additional agreements, and the seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **first tuesday** Forms 152 and 304];
- verification of payment history of rent payments or mortgages [See **first tuesday** Forms 212 and 212-1];
- Residential Appraisal Report – Detached Single Family Unit or PUD [See **first tuesday** Form 200 (HUD Form 1004)];
- notice to the homeowner regarding possible refunds and MIP; and
- Lead-Based Paint Disclosure signed by the buyer. [See **first tuesday** Form 313]

Editor's note — As of this writing in 2012, the down payment under a Section 203(b) program may be as little as 3.5%.

For the privilege of making a **small down payment**, the buyer must pay a *mortgage insurance premium (MIP)* to FHA which effectively increases the annual cost of borrowing as an addition to interest.

Annual premiums, which are paid monthly, and *upfront premiums*, which are paid only once on the origination of the loan, have been revised in 2012 to conform to the following guidelines:

- annual MIPs for loans under **$625,500** have increased to 1.25% of the loan amount, up from 1.15%;
- annual MIPs for loans **$625,500** and higher have increased to 1.5% of the loan amount, up from 1.15%; and
- **upfront premiums** have increased to 1.75% of the loan amount, up from 1%.

Acceptable sources of the cash down payment include:

- **Savings and checking accounts:** Lenders must verify the account balance is consistent with the buyer's typical recent balance and no large increase occurred just prior to the loan application.
- **Gift funds:** The donor of the gift must have a clearly defined interest in the buyer and must be approved by the lender. Relatives or employer unions typically are acceptable donors. Gift funds from the seller or broker are unacceptable kickbacks and are considered an inducement to buy and require a reduction in the sale price.
- **Collateralized loans:** Any money borrowed to meet the down payment requirement must be fully secured by the buyer's marketable assets (i.e., cash value of stocks, bonds, or insurance policies), which do not include the home being financed. Cash advances on a credit card, for example, are not acceptable sources for down payment funds.
- **Broker fee:** If the buyer is also a real estate agent involved in the sales transaction, the commission may be part of the buyer's down payment.
- **Exchange of equities:** The buyer can trade personal property he owns to the seller as the down payment. The buyer must produce evidence of value and ownership before the exchange will be approved.
- **Sale of personal property:** Proceeds from the sale of the buyer's personal property can be part of the down payment if the buyer provides reliable estimates of the value of the property sold.
- **Undeposited cash** is an acceptable source of down payment funds if the buyer can explain and verify the accumulation of the funds. [HUD Handbook 4155.1 Rev-5 Ch-5 §B.1]

Buyers obtaining a Section 203(b) loan must occupy the property as their **primary residence**.

Investors are prohibited from using Section 203(b) to purchase property since their intended use of the property would be as a rental, a contradiction of the owner-occupancy purpose of the Section 203(b) program.

Similarly, homeowners with Section 203(b) loans who later sell their home to investors will not receive FHA approval of the sale.

The public policy rationale behind the Section 203(b) program is based on the proposition that individuals who become homeowners have proven in their later years to be less of a financial burden on the government than the burden imposed by life-time renters.

No consideration is given when inducing homeownership to the risks a buyer takes on by the debt burden accompanying an FHA-insured home loan and reduced job mobility during economic downturns.

Under Section 203(b), a loan for the purchase of an **additional residence** will be insured by FHA in the case of hardship to the buyer, such as relocation due to a job. FHA insurance was created to give home sellers the mobility needed to sell and relocate to better jobs. In effect, the mobility of the nation's home-owning work force is not to be hampered for lack of highly leveraged financing. [HUD Mortgagee Handbook 4155.1 Rev-5 Chapter-4 §B.2.d]

FHA loan limits by area

The FHA insures lenders against loss for the full amount of loans made to buyers under the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, a Section 203(b) mortgage. The maximum FHA-insured loan available to assist a buyer in the purchase of one-to-four unit residential property is determined by:

- the type of residential property; and
- the county in which the property is located.

A list of counties and their specific loan ceilings is available from FHA or an FHA direct endorsement lender, or online from the Department of Housing and Urban Development (HUD) at *http://www.hud.gov*.

Loan-to-value (LTV) ceilings

The FHA sets limitations on the amount of a loan it will insure, based on a percentage of the appraised value of the property, called the *loan-to-value (LTV) limitation* or *ratio*.

The **LTV limitations** on an FHA-insurable loan are capped at 96.5%. Thus, the minimum down-payment is 3.5%. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.b]

Additionally, even after including buyer-paid closing costs in the LTV calculations, the insurable loan amount cannot exceed the ceiling of 96.5% of the property's appraised value.

To determine the loan amount the FHA will insure, multiply the appropriate LTV ratio by the lesser of the property's:

- sales price; or

- the appraised value of the property. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.a]

Closing costs may not be used to help meet the 3.5% minimum downpayment requirement. Also, closing costs are not deducted from the sales price before setting the maximum loan amount. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.d]

Such costs include the lender's origination fee, appraisal fees, credit report charges, home inspection fees, recording fees, survey fees and the cost of title insurance.

Programs for investors

Despite HUD's general no-investor policy, FHA will insure loans made to investors for these projects:

Mobilehome parks — Finance construction of mobilehome parks consisting of five or more spaces. The park must be located in a HUD approved location where market conditions show a need for this type of housing. [Section 207]

Multifamily rental housing — Finance construction containing at least five units and all must be rented at reasonable prices. [Section 207]

Housing for the elderly — To finance the construction or rehabilitation of housing consisting of at least five units, all of which must be suited to the elderly or handicapped. Convalescent homes are not included in this section. [Section 231]

Nursing homes — To construct or renovate care facilities which accommodate 20 or more patients who require skilled nursing care. Nursing homes, intermediate care facilities, and board and care homes are acceptable types of care facilities. Major equipment needed to operate the facilities can be included in the loan. [Section 232]

Low-income rental assistance — Investors who own housing occupied by low-income tenants can apply for HUD assistance with tenant's rent payments. Under the Section 8 program, HUD makes up the difference between what a low-income tenant can afford to pay and the approved rent for the unit HUD rental assistance subsidies can be obtained for existing housing occupied by tenants whose income is less than 50% of the median income for the area. In addition to rental assistance to property owners, HUD also provides rental vouchers and rental certificates to tenants. [Section 8]

Either the buyer or seller can pay the buyer's closing costs, called *non-recurring closing costs*. The lender may also advance closing costs on behalf of the buyer.

Discount points or upfront MIPs are not part of the buyer's closing costs since they are considered prepaid interest.

However, when the seller pays the buyer's loan discount points and MIPs, these amounts are then considered *financing concessions.*

Any closing costs or other financing concession paid by the lender or seller in excess of 6% of the property's sales price is considered an *inducement to purchase* and results in a dollar-for-dollar deduction of the excess from the sales price before applying the appropriate LTV ratio. [HUD Handbook 4155.1 Rev-5 Ch-2 §A.3]

The LTV ratio initially sets the loan amount. However, the loan amount cannot exceed the cap of 96.5% of the appraised property value.

Credit approval

Before FHA will insure a loan, the lender must determine if at least one of the co-applicants is creditworthy. [24 Code of Federal Regulations §203.512(b)]

For a buyer to be creditworthy for FHA mortgage insurance, the following debt-to-income ratios must be met:

- the buyer's **mortgage payment** may not exceed 31% of the buyer's gross effective income, called the *mortgage payment ratio*; and

- the buyer's **total fixed payments** may not exceed 43% of the buyer's gross effective income, called the *fixed payment ratio*. [HUD Handbook 4155.1 Rev-5 Ch-4 §F.2]

A buyer's income consists of his salary and wages. Social security, alimony, child support, and government assistance are factored into the buyer's income to determine his *effective income*. The buyer's **effective income** before any reduction for the payment of taxes is called his *gross effective income*.

The maximum **mortgage payment ratio** of 31% of the gross **effective** income determines the maximum amount of principal, interest, taxes and insurance the buyer is able to pay on the mortgage.

Lenders use the maximum **fixed payment ratio** of 43% of the gross effective income to determine whether a buyer can afford to incur the long-term debt of an FHA-insured mortgage in addition to all other long-term payments he must make.

When computing the fixed-payment ratio, the lender adds the buyer's total mortgage payment to all the buyer's recurring obligations (debts extending ten months or more), such as all installment loans, alimony and child support payments, to ascertain the buyer's total monthly fixed payments. [HUD Handbook 4155.1 Rev-5 Ch-4 §C.4]

However, even if the buyer's ratios exceed FHA requirements, the loan may be approved if the buyer:

- makes a large down payment;
- has a good credit history;
- has substantial cash reserves; and
- demonstrates potential for increased earnings due to job training or education, called *compensating factors*. [HUD Handbook 4155.1 Rev-5 Ch-4 §F.3]

Since **predetermined ratios** may not indicate a particular homebuyer's likelihood for default, lenders may be flexible when applying the qualification ratios.

For example, if the buyer's debt-to-income ratios are above the prescribed maximum, the FHA may still insure the loan based on these compensating factors.

Although FHA considers good credit history and a large down payment to be compensating factors, lenders will not fund a loan in practice based on these two factors alone unless the buyer meets the prescribed payment ratios.

Due-on-sale clause

Loans insured by the FHA contain a due-on-sale clause which allows the FHA to accelerate the loan if the property is sold in violation of assumability requirements.

The lender of a Section 203(b) loan cannot impose restrictions on the resale of the property or automatically call the loan due-on-sale.

However, to avoid defaults by future owners, when a homeowner with a Section 203(b) loan sells the home, the lender is allowed to approve the sale if:

- one of the new owners is creditworthy;
- the seller retains an ownership interest; or
- the transfer is through a will.

If an FHA-insured property is sold to an unapproved buyer, such as an investor, the lender may request permission from the FHA to accelerate the loan. Only when the FHA approves a call may the lender call the balance of the loan due-on-sale. The FHA has not called any loans under the due-on-sale clause since the policy was initiated in 1985. [24 CFR §203.512]

Investors will not be approved as buyers of property which is subject to a Section 203(b) loan since the property would be a rental and not the investor's primary residence. However, in spite of the FHA's no-investor policy, once an investor purchases a property subject to a Section 203(b)-insured loan, the FHA only requires the investor to make payments as scheduled.

Further, race, religion, sex, handicap, familial status, sexual orientation and ethnicity are not compensating factors for evaluating a loan application.

Conversely, a lender cannot deny the loan application of an African-American buyer in an attempt to exclude African-Americans as buyers of homes located in a particular neighborhood. [**Holmes** v. **Bank of America** (1963) 216 CA2d 529]

However, lenders in California can establish loan programs which promote homeownership in ethnic minorities or low-income neighborhoods, provided the programs comply with the federal Fair Housing Act or similar state and federal laws. [Calif. Health and Safety Code §35810]

RESPA and TILA disclosures

The Real Estate Settlement Procedures Act (RESPA) requires any lender making an FHA-insured loan to deliver *good faith estimates* of **settlement costs** paid to providers of services on the sale of a one-to-four unit residential property and a Housing and Urban Development (HUD) information booklet within three days after receiving the buyer's application. [See **first tuesday** Form 204-5 (HUD-GFE)]

The HUD information booklet contains information about real estate transactions, settlement services and consumer protection laws. [24 CFR §3500.6 (a)(3)]

Upon closing a sale, an escrow agent handling the loan must deliver to the buyer and seller a **HUD-1 closing statement**, also known as a *settlement statement*, detailing all loan related charges incurred by the buyer and seller. [24 CFR §3500 et seq.; see **first tuesday** Form 402 (HUD-1)]

Editor's note — As of this writing in 2012, the Consumer Financial Protection Bureau (CFPB) is in the process of updating both the GFE and settlement statement. The revisions are designed to make the forms more uniform, clutter-free and user-friendly, better enabling the borrower to shop around for the most competitive rates.

The proposed changes include:

- *new methods for calculating the Annual Percentage Rate (APR);*
- *new methods for calculating lender finance charges; and*
- *the effective date for certain disclosures.*

first tuesday *will make both updated forms available at www.firsttuesday.us as they become available.*

Further, the *Truth-in-Lending Act* (TILA), referred to as *Regulation Z*, requires lenders making loans for *personal use* (i.e., the purchase of a personal residence) to disclose details about the **loan terms**, such as the amount funded, direct loan costs, payment schedules, the loan's annual percentage rate (APR), and the interest rate. [See **first tuesday** Form 221]

NOTICE OF RIGHT TO RESCIND

Borrower's Right to Cancel

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

NOTE: This notice only applies when an equity loan or refinance which funds a personal use will be secured by one-to-four unit residential property presently owner-occupied by the Borrower as his principal residence.

FACTS:

1. This notice is given in a loan transaction under an application or loan numbered ____________________,
   - 1.1 between you ____________________, as the Borrower, and
   - 1.2 ____________________, as the Lender,
   - 1.3 in which ____________________ is the mortgage loan Broker,
   - 1.4 for an amount borrowed of $____________, which is or will be secured by
   - 1.5 property you own located at ____________________.

NOTICE:

2. You are entering into a transaction which will result in a lien on your home. You have a legal right under federal law to cancel this transaction, without cost, within three business days from whichever of the following events occurs last:
   - 2.1 the date of this transaction which is ____________, 20______;
   - 2.2 the date you received your Truth in Lending disclosures; or
   - 2.3 the date you received this notice of your right to cancel.
3. If you cancel the transaction, the lien is also cancelled.
   - 3.1 Within 20 calendar dates after we receive your notice, we must take steps necessary to reflect the fact that the lien on your home has been cancelled, and we must return to you any money or property you have given to us or anyone else in connection with this transaction.
4. You may keep any money or property we have given you until we have done the things mentioned above, but you must then offer to return the money or property.
   - 4.1 If it is impractical or unfair for you to return the property, you must offer its reasonable value. You may offer to return the property at your home or at the location of the property. Money must be returned to the address below. If we do not take possession of your money or property within 20 calendar days of your offer, you may keep it without further obligation.

How to Cancel:

5. If you decide to cancel this transaction, you may do so by notifying us in writing, at (creditor's name and business address) ____________________
   ____
6. You may use any written statement that is signed and dated by you and states your intention to cancel, or you may use this notice by dating and signing the cancellation provision below.
   - 6.1 Keep one copy of this notice because it contains important information about your rights.
7. If you cancel by mail or telegram, you must send this notice no later than midnight of ____________, 20______ (or midnight of the third business day following the latest of the three events listed above at §2).
   - 7.1 If you send or deliver your written notice to cancel some other way, it must be delivered to the above address no later than the time stated above.

Borrower acknowledges receipt of two copies of this notice.

Date: ____________, 20______

Borrower's Signature: ____________________ Borrower's Signature: ____________________

Notice of Rescission by Borrower:

I hereby cancel this transaction.

Date: ____________, 20______

Borrower's Name: ____________________ Signature: ____________________

Borrower's Name: ____________________ Signature: ____________________

FORM 222 03-11

Scan this QR-Code for a PDF of the Form!

Loans insured by the FHA under section 203 (b) are subject to both disclosure requirements since they fund personal use loans (TILA) and are federally related loans (RESPA). Thus, RESPA and TILA disclosures on FHA-insured loans are delivered together by the lender within three business days after receiving the buyer's loan application. [12 CFR §226.19] If the lender adjusts the annual percentage rate (APR) by more than 1/8 (one eighth) of 1% from the rate initially offered after receiving the buyer's loan application, the lender must **redisclose** the new adjusted APR before the buyer signs the loan documents. [12 CFR §226.19(a)(2)]

Lenders are not required to give the three-day right of rescission to buyers obtaining an FHA-insured home loan under the owner-occupied, one-to-four family home mortgage insurance program, Section 203(b), since the right to rescind does not apply to purchase-assist financing of **residential sales,** only to personal-use equity loans secured by any type of property. [12 CFR §226.23(f)(1); see Form 222 accompanying this chapter]

Editor's note — In practice, lenders of residential purchase-assist loans generally give the right of rescission, although they are not obligated to do so. If given the right to rescind by the lender, the buyer may rescind the loan transaction up to three days after signing the loan documents. [12 CFR §226.23]

Before closing, lenders must also hand buyers a prepayment disclosure statement informing buyers they can prepay any or all of the remaining balance of the loan without a **prepayment penalty** on any installment due date. [24 CFR §§203.22(b), 203.558(a)]

The prepayment of loans insured by the FHA should be made on a regular installment due date, since some lenders charge interest on the amount owed through the end of the month if the loan is prepaid during the month between due dates.

Personal liability

When an owner sells his property subject to an existing FHA-insured loan and the buyer takes over the loan, the seller will be released from personal liability for that loan, if:

- he requests a release from personal liability;
- the prospective buyer of the property is creditworthy;
- the prospective buyer assumes the loan; and
- the lender releases the seller from personal liability by use of an FHA-approved form. [HUD Form 92210; 24 CFR §203.510(a); HUD Handbook 4155.1 Rev-5 Ch-7]

If the conditions for release from personal liability are satisfied, but the seller does not **request a release**, he remains liable to the FHA for any default occurring within five years after the sale. [12 USC §1709(r)]

However, if five years pass from the time the property is resold, the seller is released from personal liability if:

- the buyer assumes the loan with the lender;
- the loan is not in default by the end of the five-year period; and
- the seller requests the release of liability from the lender. [24 CFR §203.510(b)]

Lenders must inform borrowers of the procedure for obtaining the release from personal liability on resale when the loan is originated. [24 CFR §203.510(c)]

Buyer liability on a default

If a buyer defaults on an FHA-insured loan, the FHA covers the lender against loss on the entire remaining balance of the loan, unlike PMI and insurance from the Veterans Administration (VA) which only insures a portion of the total loan amount.

After the lender acquires the property through foreclosure and conveys the property to the FHA, the FHA pays the lender the amount of the remaining original principal on the loan at the time of foreclosure of a property insured by the FHA. If a bidder other than the lender acquires the property at the foreclosure sale, the FHA pays the lender the amount of the unpaid principal balance, minus any amounts the lender receives from the bidder. [24 CFR §203.401]

Before accepting a conveyance from the lender, the FHA requires the lender to confirm the property is in a marketable condition and has not suffered any waste. The FHA then sells the property to recoup the amount it paid to the lender.

Unlike conventional home loans where only a lender is involved, a homebuyer who takes out an FHA-insured loan with a lender is personally liable to the FHA under the mortgage insurance program for any loss the FHA suffers as a result of the homebuyer's default.

When the FHA suffers a loss, the FHA can obtain a money judgment against the homebuyer for the difference between the amount the FHA paid the lender and the price received from the sale of the property. California anti-deficiency mortgage laws do not apply to FHA-insured loans. [24 CFR §203.369]

Chapter 67 — Private mortgage insurance

This chapter presents the availability of private insurance (PMI) on high loan-to-value mortgages for the purpose of covering lender losses on a default by the borrower.

For a further discussion of this topic, see Chapter 40 of Real Estate Finance.

Chapter 67 Outline

Protecting the lender from loss
Private mortgage insurance coverage
Who pays for PMI?
The leveraged buyer and PMI
Buyer standards
PMI's type of property
Qualifying the loan for PMI
Defaulting borrower and PMI recourse
The PMI credit check

Chapter 67 Terms

Common interest development	*Loan-to-value ratio*
Genworth Financial	*MGIC Investment Corp.*
Lender-Paid Mortgage Insurance	*Private mortgage insurance*

Protecting the lender from loss

Private mortgage insurance (PMI) indemnifies a lender for financial loss on a loan secured by an interest in real estate when a **borrower defaults**. [Calif. Insurance Code §12640.02]

The lender's recoverable losses include principal on the debt, any deficiency in the value of the secured property, and foreclosure costs, but exclude losses due to flood, earthquake or fire damage, which are separately insurable.

Also, PMI is not mortgage life insurance. Mortgage life insurance pays off the insured loan in the event a borrower dies, becomes disabled, or loses his health or income.

Private mortgage insurers are unrelated to government-created insurance agencies, such as the Federal Housing Administration (FHA) and the Veterans Administration (VA), which also insure or guarantee loans made to qualified trust deed borrowers.

Loans insured by the FHA, VA, and the California Department of Housing and Community Development (HCD) have their own guidelines and are not subject to laws controlling PMI.

Private mortgage insurance coverage

PMI insures a percentage of a real estate loan. In turn, the loan amount represents a percentage of the property's value, called the *loan-to-value ratio (LTV).*

Typically, loans insured by PMI, including fixed-rate mortgages (FRMs) and adjustable rate loans (ARMs) for purchase-assist or refinancing, are covered for losses on loan amounts exceeding 67% of the property's value at the time the loan is originated.

PMI is available in California through two primary insurers:

- *MGIC Investment Corp. (MGIC)*; and
- *Genworth Financial*.

PMI was previously available through *PMI Group*, the nation's third largest private mortgage insurer, which filed for Chapter 11 bankruptcy in November 2011.

Who pays for PMI?

The buyer usually pays the PMI premiums, not the lender, although the lender is the insured and holder of the policy.

However, some lenders and PMI carriers offer a *Lender-Paid Mortgage Insurance (LPMI) program*. If issued by the PMI carrier, the lender will pay the mortgage insurance premium (in a lump sum or on a monthly basis) and in turn charge the borrower a higher interest rate on his principal payments.

Premium rates are set as a percentage of the loan balance and are calculated in the same manner as interest.

When the buyer qualifies for PMI and a policy is issued, the lender must notify the buyer at the time of closing and each year thereafter of the buyer's right to cancel the PMI.

Later, if the buyer is current on his PMI payments and has taken out no other loans on his property, he may request the termination of his PMI when the equity in his property reaches 20% of its value at the time the loan was originated. PMI will be canceled automatically once the buyer reaches 22% equity in his property (unless the loan is a piggyback 80-10-10 loan).

Furthermore, the buyer may cancel his PMI two years after the loan is recorded. However, the buyer may not cancel his PMI until the LTV for the loan balance is 75%, unless the lender has agreed to a higher LTV. Also, if monthly installments on the note during the year prior to the request for cancellation are more than 30 days overdue, or if the buyer has other liens on the property, the lender or private insurer will not terminate the PMI. [Calif. Civil Code §2954.7]

If cancellation of PMI is permissible, the lender under the note may not charge advance PMI payments unless the borrower has incurred more than one late penalty in the past 12 months, or has been more than 30 days late on one or more payments on the note. [CC §2954.12]

Premiums charged by PMI insurers do not include an up-front fee on origination, only an annual fee calculated as a percentage of the loan balance.

The leveraged buyer and PMI

The individual or couple looking for housing to own and occupy as their primary residence must first compile cash or cash equivalence for a **downpayment** in an amount greater than 20% of the price of the housing they want for shelter. If not, they must be able to qualify and pay for the cost of **default insurance**, known as **PMI**.

If they have accumulated cash for a downpayment of 10% or more, they may be able to qualify for PMI through **MGIC** or **GenWorth Financial.**

Thus, they will avoid the more lenient yet more expensive government insured mortgage plans (interest and premiums) available for homebuyers with less than 10% cash accumulated for a downpayment.

The lender making a conventional loan to fund the purchase of a principal residence when the loan will exceed 80% of the property value will require the buyer to meet the qualifications for PMI coverage, not just the lender's qualification requirements.

Thus, PMI qualification requirements become the lender's minimum requirements for making the loan.

Buyer standards

In distressed California, depending on the policies of the insurer, the buyer must meet standards such as:

- a minimum credit score of upwards of 680 with no exceptions and at least three trade lines supporting the credit score;
- a debts-to-income ratio between 41% and 45%;
- two months PITI payments in cash reserves on closing is waived;
- employment full time during the past two years, a current pay stub, written *verification by employer* (VOE form), and telephone confirmation of employment at closing, unless self-employed;
- if self-employed, financial statements for two prior years and year-to-date, IRS tax returns;
- legal residence in the USA;
- all documents and title vestings to be in the name of the buyer as an individual, as no entities or alternative vestings qualify;

- limit to three loans under PMI coverage in name of buyer;
- completion of a homeowners course of education on mortgage debt obligations;
- no bankruptcy within four years, unless excused by extenuating circumstances in which case the penalty box for ostracizing the buyer (even though otherwise fully qualified) is two years; and
- no prior foreclosure under a mortgage.

Pre-approval letters from a lender will likely be limited to a credit score investigation and, if self-employed, a review of employment or financial statements to workup the **debts-to-income (DTI)** ratios.

The PMI full *documentation efficiency* investigation will take place after submission of a loan application and, as usual, will essentially be limited to verification of all the buyer's representations on the application.

PMI's type of property

The availability of PMI coverage for different types of California real estate is now severely limited. This condition for coverage will remain until the real estate market is no longer stressed with the prospect of declining property values. Only properties classified as **single family residences (SFRs)** are now provided with PMI.

Also, SFRs are further categorized as either detached or condos, the distinction reflected in the amount of downpayment required for PMI. Thus, the property type drives the downpayment amount needed before the lender will make a loan on purchases with less than a 20% downpayment.

For California **property to qualify** for PMI coverage, the property must meet standards which vary depending on the insurer, such as:

- use of the property to be as the principal residence of the buyer on closing;
- vesting of title to the property to be in the name of the individual(s) purchasing the property;
- ownership is not to be for investment;
- detached SFR property not located within a *common interest development (CID)* or *homeowners' association (HOA)* to be acquired with a minimum 10% downpayment;
- SFR units within a **CID** to be acquired with a minimum 15% downpayment, if the HOA meets certain standards.

Thus, investors and speculators are not welcomed; only buyer-occupants of SFRs need apply for PMI, until the competition among PMI insurers heats up, lenders start pushing the PMI insurers around (again) or the market returns to allow the PMI insurer a profit, a restructured capitalization and a firm grip on the rate of losses from foreclosures. The light at the end of that tunnel has not yet come into view.

Qualifying the loan for PMI

Current economic forces have narrowed the classification of loans PMI insurers will cover based on the likelihood of a foreclosure within different types of loans.

Loans favored by PMI insurers include FRMs for amounts less than 90% of the property value which fund the purchase of a detached SFR acquired by a buyer who intends to occupy it as his principal residence.

All other loans are disfavored, and are avoided by imposing more stringent requirements to qualify for PMI or refusing them coverage since they present risks insurers are no longer willing to accept for any amount of premium.

For a loan to qualify for PMI, its terms and conditions must meet certain requirements which very depending on the insurer, such as:

- maximum loan amount of $533,850;
- funding of a purchase-assist acquisition of a principal residence by a buyer

Submitting PMI claim

Consider a lender whose loan is secured by a first trust deed on a personal residence in default.

The lender forecloses on the property by a trustee's sale and acquires the property by bidding the dollar amount of its current fair market value (FMV). The lender then submits its claim to the insurer, including documents showing the price bid at the trustee's sale and a recent appraisal of the property.

If the owner of the property is in default, and the insured lender is willing to work out a short sale, the PMI carrier must be notified immediately of the impending short payoff. PMI will not cover loan discounts on short sales unless the owner is **in default**.

Additionally, PMI policies contain a physical damage exclusion which provides that PMI the carrier can require any damage to the secured property totaling more than $1,500 be repaired before the carrier will pay the lender's claim.

In the event the improvements are totally destroyed due to a catastrophe such as a fire or an earthquake, the PMI carrier is not obligated to pay the lender on a default until the improvements and the lender's LTV prior to the damage have been restored.

- a 90% LTV for a detached SFR not located within a CID/HOA;
- an 85% LTV for a unit located within a CID/HOA;
- maximum 40 year amortization schedule, as no interest-only or option payment loans are insurable;
- fixed rate loans; and
- adjustable rate loans if the rate is fixed for the first five years and on the rollover into an ARM they have no possibility of negative amortization.

Defaulting borrower and PMI recourse

Most PMI contracts do not authorize the carrier to seek **indemnity** from the borrower for claims made on the policy by the lender — unlike Federal Housing Administration (FHA) or Veterans Administration (VA) insurance programs which place homeowners at a risk of loss for a greater amount than their down payment.

However, if the loan is recourse such as refinancing, the lender's right to seek a deficiency judgment may be assigned to the PMI carrier. Pursuing a money judgment for a deficiency in the value of the property requires a judicial foreclosure action in lieu of a trustee's foreclosure sale.

However, most insured loans are *purchase-money loans* made to buyer-occupants to acquire their principal residence. Purchase money loans are **nonrecourse obligations**, with recovery on the loan limited to the value of the real estate. [Calif. Code of Civil Procedure §580b]

In the case of fraud on recourse or nonrecourse loans, the PMI carrier is not barred by anti-deficiency statutes and will be able to enforce collection of his losses against the borrower for misrepresentations, such as the property value.

The PMI credit check

To qualify for PMI, the buyer must:

- be a natural person, not a corporation, partnership or limited liability company (LLC); and
- take title as the vested owner of the property.

The lender, when qualifying the buyer for a loan to be covered by PMI, relies on the more restrictive PMI insurer's requirements regarding the buyer's:

- liquid assets after closing;
- debt-to-asset ratio;

- debt-to-income ratio; and
- regard for financial obligations.

A buyer required to qualify for PMI before a lender will fund a loan undergoes an in-depth risk analysis based on the PMI carrier's eligibility requirements.

Lenders often turn down applications for loans due to the buyer's inability to qualify for PMI. At a minimum, the buyer will be required to submit documents for review by the PMI insurer, including:

- a copy of the loan application;
- a credit report current within 90 days and covering a minimum of two years; and
- an appraisal of the real estate to be purchased.

However, the PMI carrier may also require additional documentation to verify the loan transaction fulfills the insurer's underwriting requirements, including:

- verification the buyer will occupy the property;
- verification the land value of the property does not exceed 40% of the total value of the property;
- a copy of the signed purchase agreement/sales contract;
- verification of funds for closing;
- verification of the buyer's salary/wages, including overtime and second jobs; and
- verification of employment.

The buyer's credit rating and disposable income must clearly support his ability to make the monthly payments on the low down payment loan.

Chapter 68 — Usury and the private lender

This chapter explains the private lender's exemption from usury limitations when the loan is arranged by using a licensed real estate broker.

For a further discussion of this topic, see Chapter 41 of Real Estate Finance.

Chapter 68 Outline

Broker arranged loans avoid usury
Usury exemptions spur competition
Interest paid with goods and services
Setting the interest rate
Usury law and real estate loans
Exceptions for private parties
Penalties for usury
Agents and usury

Chapter 68 Terms

Debt	*Made or arranged*
Federal discount rate	*Threshold rate*
Home equity loans	*Usury laws*
Loan sharking	

Broker arranged loans avoid usury

When a loan is made, the lender charges the borrower **interest** for use of the money during the period lent. However, the amount of interest a private, non-exempt lender can charge is regulated by statute and the California Constitution, called *usury laws*. [Calif. Constitution, Article XV; Calif. Civil Code §§1916-1 through 1916-5]

Today, the remaining goal of usury laws is the prevention of **loan-sharking** by private lenders — charging interest at a higher rate than the ceiling-rate established by the usury laws, a *threshold rate of interest* beyond which the non-exempt loan becomes categorized as *usurious*. [CC §1916-3(b)]

Usury exemptions spur competition

Adopted in 1918 as a consumer protection referendum, the first California usury laws set the maximum interest rate at 12% for **all lenders**; no exceptions.

During the Depression, legislators noted the adverse effect the ceiling-rate restriction on interest rates money lenders could charge was having on the money supply and the economy.

So, in 1934, usury laws were constitutionally amended in a trade off — lowering the maximum rate to 10% while exempting several classes of significant lenders entirely.

Lenders such as *savings and loan associations (S&Ls)*, state and national banks, industrial loan companies, credit unions, pawnbrokers, agricultural cooperatives and personal property brokers could lend at whatever rate the market would bear without fear of penalty *by forfeiture of interest earnings*.

Exemptions successfully opened the market by increasing the availability of funds. In turn, interest rates were driven lower due to increased competition.

When money grew tight again in the late 1970s, legislators applied the same strategy to loosen up what had by then become massive amounts of funds held by individuals in savings accounts by initiating a proposition in 1979.

On passage of the 1979 initiative, real estate loans **made or arranged** by real estate brokers were added to the list of usury-exempt lender situations. [Cal. Const. Art. XV]

The 1979 law also gave the legislature the power to exempt other classes of lenders from usury limits. The legislature has since exempted corporate insurance companies and consumer finance lenders, but not CalPers.

Interest paid with goods and services

When a borrower pays interest on a loan, he is really paying rent to the lender for use of his money for a period of time. The money lent is fully repaid during or at the end of the period.

Normally, the amount of interest charged is a fixed or adjustable percentage of the amount of money loaned.

Though interest is commonly paid with money, interest may also be paid with personal property or services. The many **types of consideration** given for making a loan become part of the lender's yield on the loan—interest. [CC §1916-2]

Thus, interest includes the value of all compensation a lender receives for lending money, whatever its form, excluding reimbursement or payment for loan origination costs incurred and services rendered by the lender. [CC §1915]

However, it is common for **non-exempt private lenders** to attempt to evade the usury law restrictions on interest and the payment of taxes by including bogus charges or claiming fees—points for their making the loan.

Any lender can charge the borrower a bonus, commission or discount, or receive services or goods from the borrower. However, charges and receipts are considered interest only when they do not compensate or reimburse the lender for services rendered in the process of originating the loan.

Determining the Federal Discount Rate

The discount rate set periodically by the Federal Reserve Bank of San Francisco (FRBSF) is the rate the "fed" charges member banks on advances of funds – money lent by the fed.

The discount rate is reviewed no less than once every fourteen days by the Board of Directors of the Federal Reserve Bank of San Francisco. A review can bring a change in the discount rate – depending on how the directors view the economic health of the region, nation and world. For monthly updates of the Discount Rate, see the **first tuesday** Rate Page at http://blog.firsttuesdayjournal.com.

The maximum interest rate allowable beyond the 10% minimum threshold rate for usury limitations is calculated and set for each month. The usury threshold rate set for a particular month applies to only those loan transactions entered into any time during that month, a fixed rate attached to that loan for the life of the loan.

The Federal Reserve discount rate used to calculate the usury threshold rate for loans agreed to during a particular month is the San Francisco Federal Bank rate for the 25th day of the previous month.

A loan transaction falls within a particular month based on the date of the earlier of:

- entering into the agreement to make the loan; or
- the funding of the loan if no prior agreement has been entered into for the non-exempt lender.

For example, a private lender signs loan escrow instructions on April 22, agreeing to fund the loan in two weeks, closing in the month of May. The lender is not a party to any prior loan agreement. The borrower's loan application was received by the mortgage loan broker (MLB) in the prior month of March.

The Federal Reserve discount rate applicable to April is 7%, April being the month the loan escrow instructions (or other loan agreement) were signed – entered into – by all parties.

The interest rate agreed to is 12% -- the maximum yield permitted without triggering the usury threshold rate controlling non-exempt private lenders who make real estate loans entered into in the month of April (7% plus 5%).

However, on April 25th, the Federal Reserve discount rate is 6%, not the 7% it was on the 25th of March. Thus, the FRBSF rate applicable for the month of May is 6%.

Prior to closing in May, the borrower claims his loan interest rate should fall to 11% to reflect the change, because the 12% agreed to in the loan is a usurious yield for loans funded during the month.

However, 7% was the Federal Reserve discount rate in effect on the 25th day of April, the month during which the lender first committed – by signing the loan escrow instructions or other agreement – to make the loan.

Since the commitment to make the loan occurred earlier than the funding, the rate for the month in which the lender's commitment occurred controls – even though the loan was funded in a following month with a different, lower rate for loan commitments made during that month.

Editor's note – Contingent interest, such as increased interest received on an adjustable rate loan (ARM), is not subject to usury limitations, unless the ARM contained a note rate in excess of usury limitations when originated, or the ARM was designed with an intent to evade usury laws [McConnell v. Merrill Lynch, Pierce, Fenner & Smith, inc. (1978) 21 C3d 365]

Charges unrelated to loan origination services are added to the interest stated in the note to determine the aggregate yield on the principal. The average annual yield over the life of the loan may not exceed the *threshold rate* which triggers application of the usury laws — unless the loan transaction is exempt. [**Haines** v. **Commercial Mortgage Co.** (1927) 200 C 609]

As long as the service performed or the expense incurred was necessary to the origination of the loan, the charges do not add to the lender's yield and is not considered interest. [**Klett** v. **Security Acceptance Co.** (1952) 38 C2d 770]

Examples of services and expenses not included in the interest yield include:

- appraisal, escrow and recording fees [**Ex Parte Fuller** (1940) 15 C2d 425];
- negotiation and brokerage fees paid to a third party [Ex Parte Fuller, *supra*];
- administrative costs, such as foreclosing on the defaulted loan or reconveyancing [**Penziner** v. **West American Finance Company** (1937) 10 C2d 160];
- attorney fees for legal services relating to the loan, such as preparation or review of loan documents [**Murphy** v. **Wilson** (1957) 153 CA2d 132]; and
- late charges due on loan default or prepayment penalties. [**First American Title Insurance & Trust Co.** v. **Cook** (1970) 12 CA3d 592]

Setting the interest rate

If the proceeds of a loan, including *home equity loans* funded by a non-exempt lender, are earmarked primarily for **personal, family, or household use** by the borrower, then the maximum annual interest rate is 10% per annum, whether secured or unsecured. [Calif. Const. Art. XV §1(1)]

However, loans made to fund the improvement, construction, or **purchase of real estate** when originated by a non-exempt private lender are subject to a different usury threshold rate, which is the greater of:

- 10% per annum; or
- the applicable discount rate of the Federal Reserve Bank of San Francisco (FRBSF), plus 5%.

Usury law and real estate loans

Two basic classifications of private loan transactions exist relating to interest rates private lenders may charge on real estate loans:

- **brokered** real estate loans; and

- **restricted** or **non-brokered** real estate loans.

Brokered real estate loans are exempt from usury restrictions and fall into one of two categories:

- loans **made** by a licensed real estate broker **acting as a principal** for his own account as the private lender who funds the loan; or

- loans **arranged** with private lenders by a licensed real estate broker acting **as an agent** in the loan transaction for compensation.

Restricted real estate loans are all loans made by private party lenders which are neither made nor arranged by a broker.

Editor's note — Private lenders include corporations, limited liability companies and partnerships. These entities would not be exempt from usury limitations unless operating under an exempt classification, such as a personal property broker or real estate broker.

The most common restricted loan involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured loans.

Exceptions for private parties

Private party transactions involving the creation of a *debt* which avoid usury laws break down into two categories:

- **exempt debts**, being *debts* which involve a loan or a forbearance on a loan and are broker made or arranged; and

- **excluded debts**, being *debts* which do not involve a loan.

The most familiar of the excluded "non-loan" type debts is the seller carryback.

Carryback notes executed by the buyer in favor of the seller of any real estate, secured or unsecured by the property sold or other property, are not loans of money; they are credit sales, also called installment sales.

As the debt credited in a credit sale, the seller carries back a note, secured or unsecured, at an interest rate which may permissibly be in excess of the usury threshold rate. The rate exceeding the usury law threshold is enforceable since the debt is not a loan. Thus, the carryback note is not subject to usury laws.

Penalties for usury

The most common **penalty** suffered by a non-exempt private lender is the forfeiture of **all interest** for the loan. Thus, the lender is only entitled to a return of the principal advanced on the loan. [**Bayne** v. **Jolley** (1964) 227 CA2d 630]

The lender may also have to pay a usury penalty of treble damages. [CC §1916-3]

Treble damages are computed at three times the **total interest paid** by the borrower during the one year period immediately preceding his filing of a suit and the period of litigation until the judgment is awarded.

An award of treble damages as a penalty is normally reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower. [**White** v. **Seitzman** (1964) 230 CA2d 756]

A borrower who knew at all times a loan interest rate was usurious is not likely to be awarded treble damages. Also, a lender who sets a usurious rate in complete ignorance of the illegality of usury would not be additionally penalized with treble damages.

Agents and usury

Activities of a licensed real estate sales agent are not within the broker's usury exemption, unless the agent is employed by a broker and the agent's level of participation in the transaction constitutes arranging the loan.

For a loan arranged by a salesman to be exempt from usury laws, the salesman must be working with a broker while arranging the loan. Since the salesman was not employed by or affiliated with a broker at any time during his arrangement of the loan. The loan is not exempt from usury laws. [**Dierenfield** v. **Stabile** (1988) 198 CA3d 126]

Default and foreclosure

Chapter 69 Converting nonrecourse paper into recourse paper

This chapter explains how a nonrecourse note held by a lender or carryback seller becomes recourse paper through later agreements with the property owner.

For a further discussion of this topic, see Chapter 44 of Real Estate Finance.

Chapter 69 Outline

Eliminating or substituting security
Subordination with an added risk
Choice-of-law avoids anti-deficiency rules?
Reconveying the trust deed

Chapter 69 Terms

Additional security	*Subordination*
Anti-deficiency	*Substitution of security*
Exhaustion of the security	*Vendor's lien right*
Release of the security	

Eliminating or substituting security

A seller holds a carryback note secured by a third trust deed on real estate he sold, called a *purchase-money* note since a deficiency in the value of its security is not collectible.

The buyer defaults and on investigating the financial feasibility of foreclosing and repossessing the property, the seller decides to forgo foreclosure. [See **first tuesday** Form 303]

The buyer wants to retain the property, but needs the seller to subordinate his trust deed to a new first trust deed loan.

The seller offers to reconvey the carryback trust deed in exchange for the buyer executing a new note for the debt owed, but secured by a junior trust deed on real estate other than the property sold. The buyer provides security – a trust deed position on other property – which the seller accepts.

By mutual agreement between the buyer and the seller:

- the seller cancels the purchase-money note and reconveys the carryback trust deed; and
- the buyer signs and delivers a new note and trust deed in favor of the seller, secured by other real estate owned by the buyer.

While the buyer **substituted security** for an existing debt owed to the seller, the new note merely evidences the same debt which was represented by the canceled note.

Later, the holder of the first trust deed on the substituted security forecloses, eliminating the seller's trust deed lien from title, called an *exhaustion of the security*.

Since the carryback seller's substituted security interest has been eliminated and the buyer refuses to pay, he sues the buyer to obtain a money judgment for the unpaid amount of the note.

The buyer claims the seller is barred by anti- deficiency rules from collecting on the note since the note evidences a purchase-money debt created between the buyer and the seller to finance the sale of real estate. [Calif. Code of Civil Procedure §580b]

The carryback seller claims anti-deficiency rules no longer bar him from obtaining a money judgment on the carryback debt since the debt became secured by real estate other than the property sold.

Can the seller enforce collection of a carryback debt which became secured, separately or collaterally, by property other than the property sold?

Yes! The seller can obtain a money judgment to enforce collection on the note even though it evidences a carryback debt. Anti-deficiency non-recourse rules no longer apply to a carryback debt when the debt becomes secured by real estate other than the real estate sold, called a *substitution of security*. The carryback seller was able to sue directly on the note without first foreclosing since his security interest in property other than the property sold was wiped out by the senior trust deed foreclosure. [**Goodyear** v. **Mack** (1984) 159 CA3d 654]

If a seller is barred from obtaining a money judgment to enforce collection of a carryback note, secured by property other than the property sold, the buyer would be improperly allowed to:

- retain the property sold; and
- avoid paying the seller for the property he purchased.

Subordination with an added risk

Construction loans are naturally precarious arrangements due to the risk the improvements may never be completed to create the anticipated property value.

Consider a seller who carries back a trust deed on the sale of a parcel of real estate and later **subordinates** the trust deed to a construction loan.

Should the construction lender foreclose on the property the seller sold and wipe out the now subordinated carryback seller's trust deed lien, the seller can collect on the carryback note by obtaining and enforcing a money judgment.

AGREEMENT TO SUBORDINATE

Prepared by: Agent ______________________________ **Phone** ______________________
Broker ______________________________ **Email** ______________________

NOTE: This agreement to subordinate results in your security interest in the property becoming subject to and of lower priority than the lien of some other or later security device.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
- ☐ Purchase agreement
- ☐ Escrow instructions
- ☐ Trust deed
- ☐ ____

1.1 dated _____________, 20______, at ____, California,

1.2 entered into by ____, as the Buyer/Trustor, and ____, as the Seller/Beneficiary,

1.3 regarding real estate referred to as ____.

AGREEMENT:

2. Provided Trustor is not in default on the Beneficiary's trust deed, Beneficiary shall, on written request of Trustor, subordinate his trust deed to a new first trust deed loan to be obtained by Trustor prior to _____________, 20______.

3. The terms of the new first trust deed loan shall include:

3.1 A principal amount not to exceed $_______________.

3.2 An annual rate of interest not exceeding ______%.

3.3 Interest to accrue on the remaining balance at a ☐ fixed rate, or ☐ adjustable rate.

3.4 A term not less than ______ years, not more than ______ years.

3.5 Amortization of the loan payable monthly over _______ years, ☐ until paid, or ☐ with a final balloon payment due in not less than ______ years.

3.6 Origination fees and finance charges to be disbursed from the loan proceeds may not exceed ______ points and $_______________, respectively.

3.7 Other ____

4. ☐ Trustor shall use the net proceeds from this loan to improve the real property, both onsite and offsite. The primary construction to be ____

5. ☐ Trustor shall use the net proceeds from this loan to pay ____

6. Trustor shall receive $_______________ cash back from the loan proceeds. These funds to be used for the following purpose(s) ____

7. ☐ **NOTICE: This subordination agreement contains a provision allowing the person obligated on your real property security device to obtain a loan, a portion of which may be expended on purposes other than improvements on the real property.**

☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: __________________, 20______	Date: __________________, 20______
Buyer/Trustor: ______________________________	Seller/Beneficiary: ______________________________
Buyer/Trustor: ______________________________	Seller/Beneficiary: ______________________________

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For example, a carryback seller subordinates his trust deed to a trust deed recorded to secure a construction loan. The loan will fund the cost of improvements to be made on the property he sold. Since the carryback trust deed is subordinated to the loan, the risk of loss due to a failure of the development is thrust upon the seller.

To cover the added risk of loss presented by the buyer's need to complete the construction, the note's interest rate is increased and prepaid for the period anticipated for construction.

Here, the trust deed note becomes recourse paper since it was subordinated to the trust deed securing the construction loan. The seller is not expected to assume the risk that the value of the yet-to-be-built improvements may not prove to be adequate security for his carryback note and cause him to suffer a loss.

Thus, the developer/buyer who promises to construct improvements as **additional security** is not protected by anti-deficiency rules from personal liability should the value of the property prove to be inadequate to satisfy the carryback note which is subordinate to a construction loan. As recourse paper, the seller is allowed to collect his losses from the developer if the property value proves insufficient to satisfy the carryback note. [**Spangler** v. **Memel** (1972) 7 C3d 603]

An **agreement to subordinate** a carryback trust deed to a future construction loan does not itself cause the trust deed note to lose its nonrecourse character. [See Form 281 accompanying this chapter]

However, the note becomes recourse paper when the carryback trust deed actually becomes subordinated to a construction loan. [**Jack Erickson and Associates** v. **Hesselgesser** (1996) 50 CA4th 182]

Conversely, the actual subordination of a carryback trust deed to the buyer's purchase-assist trust deed loan, or a later refinancing of the senior trust deed loan, does not present a change in the use or nature of the property, nor provide additional security, which would need to take place in order to convert a nonrecourse note to recourse paper.

The physical property remains the same, contrary to the seller's subordination of his security interest in the property since the seller's *loan-to-value ratio (LTV)* has been altered by accepting a secured position which over encumbers the property. [**Shepherd** v. **Robinson** (1981) 128 CA3d 615]

When a carryback seller agrees to subordinate his carryback trust deed to purchase-assist financing secured only by the property sold, the subordination does not alter the character of the property sold (no construction promised) or the nonrecourse nature of the seller's (undersecured) purchase-money note. [**Lucky Investments, Inc.** v. **Adams** (1960) 183 CA2d 462]

A seller who carries back a trust deed, secured only by a subordinated interest in the property sold, is charged with knowing the value of the real estate sold and thus the value of the position accepted as security.

Letters of credit

A lender might require a borrower to obtain a letter of credit as a condition for funding a **purchase-assist loan**. Also, a seller agreeing to carryback paper might demand a letter of credit as additional security.

The lender or carryback seller can draw on a letter of credit before or after a trustee's sale without violating anti-deficiency statutes or the security first rule. [CCP §580.5(b)]

However, the letter of credit is unenforceable if:

- it is issued to a trust deed beneficiary to cover a future default on the obligation; and
- the obligation is secured by a purchase money trust deed on owner-occupied, one-to-four unit residential property. [CCP §580.7(b)]

Thus, a carryback seller or a purchase money lender on an owner-occupied, one-to-four unit residential property is barred from drawing on a letter of credit at any time.

For example, should a lack of value exist, or a market-induced reduction in the value of the property sold occur due to overpricing or a recession, the buyer is not personally liable on a seller carryback note secured by the property sold, even if the debt is later subordinated to new financing. [**Brown** v. **Jensen** (1953) 41 C2d 193]

Choice-of-law avoids anti-deficiency rules?

Consider a borrower who executes a purchase-money note secured by a trust deed on California real estate. The note contains a provision which adopts the law of another state to control the legal consequences of the financing.

The borrower and the lender are both domiciled in a state which does not have anti-deficiency laws.

The borrower defaults on the loan. The lender judicially forecloses on the property and is awarded a deficiency judgment.

The borrower claims the lender is barred from recovery by way of a deficiency judgment since the note is secured by California real estate.

The lender claims it is not barred from seeking a deficiency judgment since the transaction is governed by the law of another state which does not prohibit deficiency judgments.

Is the lender entitled to a deficiency judgment?

Yes and no! The yes part: The trust deed contained a choice-of-law provision which controlled enforcement of the California purchase-money note under **out-of-state law**. Since all parties involved were non-residents and located out-of-state, California's public policy regarding anti-

deficiency is not adversely affected since no Californians are involved. Thus, the deficiency in the value of the property sold is collectible by a money judgment. [**Guardian Savings and Loan Association** v. **MD Associates** (1998) 64 CA4th 309]

*Editor's note — The no part: The **Guardian** court's holding is limited to the narrow facts of the case, i.e., all parties were non-residents living out-of-state who choose to abide by the laws of a "recourse state." Conversely, to allow **choice-of-law provisions** applying the law of a recourse state to a resident owner of property located in California would impermissibly open the door for out-of-state lenders to circumvent California's anti-deficiency laws designed to protect its residents.*

Reconveying the trust deed

A lender or carryback seller holding a note secured by a trust deed cannot **unilaterally waive and reconvey** the note's security, then proceed against the borrower or buyer as though the now unsecured note was converted to recourse paper by the release of the security.

A *release of the security* must be **mutually agreed to** between the lender and borrower for the secured debt to become a recourse debt.

For example, a carryback seller holds a note for the balance due on the purchase price of real estate. The note is secured by a second trust deed on the property sold.

The property value has decreased below the amount owed on the note, due to a destabilized real estate market, and the buyer defaults.

The carryback seller agrees with the buyer to modify the terms of the note and release the security. He senses the security interest he holds under his trust deed lien on the property has insufficient value to protect should the first trust deed holder foreclose.

As agreed, the carryback seller reconveys the trust deed and the carryback note becomes unsecured. [See **first tuesday** Form 472]

The Modification of the Promissory Note, executed by the buyer in favor of the seller, is attached to the note as an allonge and states the changes in its terms and the release of the trust deed lien by reconveyance. [See **first tuesday** Form 425]

Later, the buyer defaults on the now unsecured note held by the carryback seller, who in turn sues the buyer for a money judgment to recover the balance due on the note.

The buyer claims anti-deficiency rules bar the carryback seller from collecting on the note since the seller's note was a purchase money obligation, created to finance the sale of the property.

However, the anti-deficiency rules no longer apply to the carryback note. The buyer and seller mutually agreed to a reconveyance of the trust deed to release the security.

The carryback seller can pursue the buyer to collect the balance due on the note since the security was released by mutual agreement.

To bar a seller from collecting on an unsecured carryback note — a note which is unsecured by mutual agreement between the seller and the buyer — would not advance the purposes of anti-deficiency rules. The buyer would be able to keep the property and pay less than the agreed-to price.

In contrast, a carryback trust deed note which becomes unsecured by mutual agreement is legally distinct from a carryback note which was **unsecured from the outset** of the sales transaction, even though both are recourse notes.

A seller who carries back an unsecured note on the close of a sales transaction has a *vendor's lien right* which he can impose on the property sold and judicially foreclose (if it is still owned by the buyer). The note was at all times unsecured and represents the amount of the purchase price remaining unpaid, contrary to the note held by the previously secured carryback seller. [Calif. Civil Code §3046]

In addition, a carryback seller or lender who requires a buyer to execute two notes for the **same debt**, one note secured by the real estate purchased, the other purportedly unsecured, is barred from collecting a deficiency. The underlying debt, evidenced in its entirety by each of the two notes, is secured by the property sold. Thus, the debt is a nonrecourse debt which can only be collected from the value of the property sold. [**Freedland** v. **Greco** (1955) 45 C2d 462]

Chapter 70 Notice of default, reinstatement and redemption

This chapter analyzes what constitutes a default on a trust deed which allows the trust deed holder to initiate foreclosure, and an owner's reinstatement and redemption rights after his default.

For a further discussion of this topic, see Chapter 45 of Real Estate Finance.

Chapter 70 Outline

Nullifying the call during foreclosure
Monetary defaults and reinstatement
Redemption
Lender remedies on a default
Trust deed defaults and reinstatement
Defaults cured only by redemption

Chapter 70 Terms

Acceleration clause	*Power-of-sale provision*
Beneficiary	*Reinstatement*
Impairment	*Redemption*
Grace period	*Waste provision*
Notice of default	

Nullifying the call during foreclosure

A lender holding a trust deed and note may call the entire principal balance of the note due and immediately payable on any default in the terms of either the note or trust deed. Trust deeds contain a boilerplate provision called an *acceleration clause* that authorizes the lender to call the loan after a material default on the trust deed.

Another provision in the trust deed, called the *power-of-sale provision*, authorizes the beneficiary to instruct the trustee appointed under the trust deed to initiate a non-judicial trustee's foreclosure to sell the property described in the trust deed.

As a result of the tandem effect of the acceleration clause and the power-of-sale provision, the trustee's recording of a *notice of default* (NOD) both initiates the trustee's foreclosure procedures and causes all sums left to be paid on the note and trust deed to become due and immediately payable.

However, before recording a **NOD**, a lender or carryback seller must first conduct or attempt to conduct a *pre-foreclosure workout* with the owner. [See Chapter 72]

Consider a homeowner who defaults on the payment of principal and interest on the note and property taxes under the trust deed. After the attempted **pre-foreclosure workout**, an NOD is recorded, commencing foreclosure to enforce payment of all sums owed under.

An investor, aware of the NOD, submits a purchase agreement offer to the homeowner which is accepted. The terms include the transfer of ownership to the investor subject to the existing note and trust deed in foreclosure. The owner will pay all delinquencies and foreclosure charges at the close of escrow from equity purchase funds received from the investor.

Escrow is opened and the escrow agent sends a request for a beneficiary statement to the holder of the note and trust deed, called the *beneficiary*. The **beneficiary** is a private party who has commenced foreclosures before on this trust deed and canceled the NODs when the homeowner paid all the foreclosure costs and brought the delinquent payments and late charges current.

The beneficiary responds to escrow's request for a beneficiary statement by sending a payoff demand, not a beneficiary statement. The beneficiary claims he is enforcing the acceleration clause in the trust deed and will only accept payment in full now that the NOD has been recorded, triggering the call.

The NOD states the **amount of the delinquencies**, past, present, and future. Thus, escrow is able to determine the amount due to cure the defaults stated in the NOD. The trustee is contacted and the total of the foreclosure fees and charges incurred by the date scheduled for close of escrow are determined.

The investor deposits closing funds with escrow on escrow's call for funds. Escrow is closed and the delinquencies and foreclosure costs are forwarded to the trustee, payable to the beneficiary in the form of the homeowner's sales proceeds.

The beneficiary rejects the sales proceeds, claiming the entire amount of his note is due as agreed in the trust deed. Further, the beneficiary claims the due-on clause in the trust deed has been triggered by the buyer's failure to obtain the beneficiary's consent to the sales transaction and now requires a full payoff of the note.

Can escrow, by tendering only the amount of the delinquencies and foreclosure costs necessary to cure the defaults, cause the note and trust deed to be brought current and reinstate the trust deed as though a default had not occurred?

Yes! After the NOD has been recorded and prior to five business days before the trustee's sale, the owner (or any junior lienholder or buyer) of the real estate encumbered by the trust deed lien that is in foreclosure can terminate the foreclosure proceedings by paying:

- the delinquent amounts due on the note and trust deed as described in the NOD and foreclosure charges, called *reinstatement* [Calif. Civil Code §2924c]; or

- the entire amount due on the note and trust deed, plus foreclosure charges, called *redemption*. [CC §2903]

Since the call triggered by a violation of the due-on clause based on the unconsented-to transfer to the investor is not stated in the NOD, the due-on call cannot be enforced under this NOD.

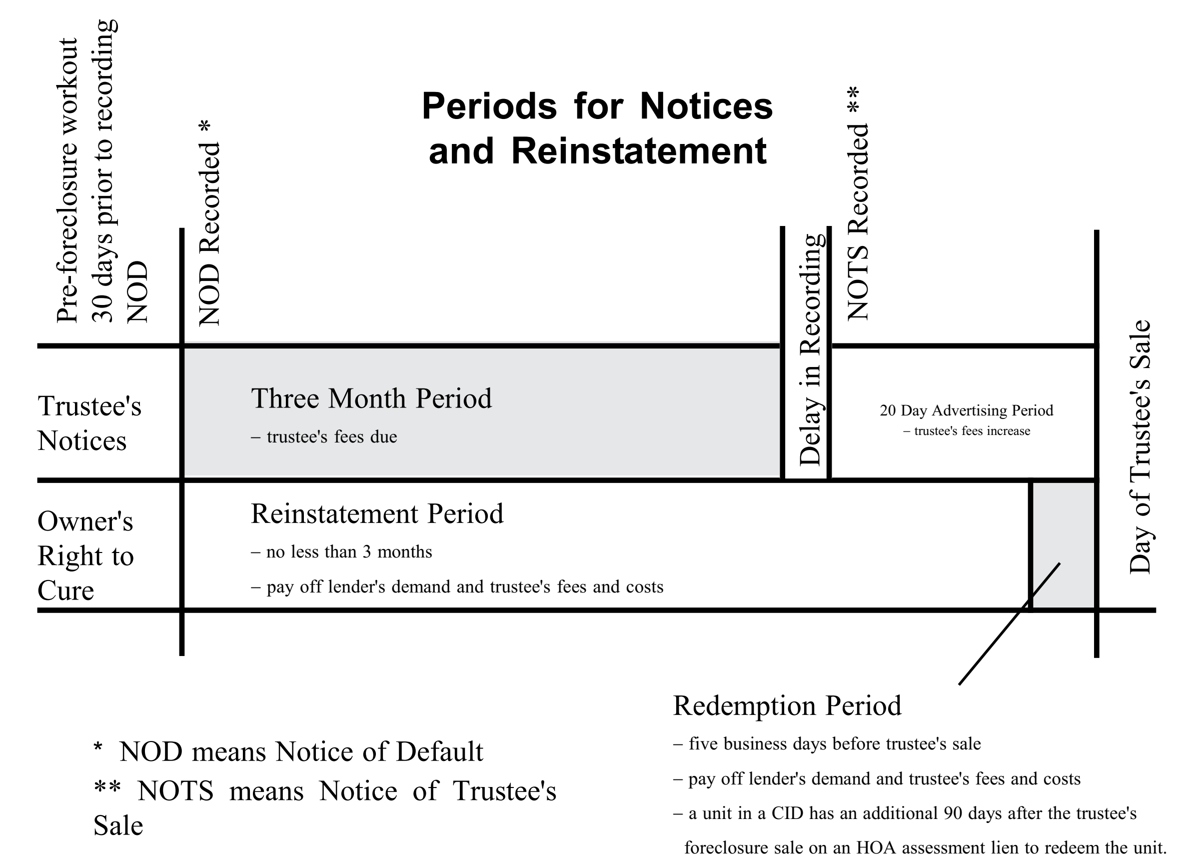
Further, if a **grace period** exists, a foreclosure may not be initiated to enforce payment of the installment until after the grace period runs, when the payment becomes delinquent if unpaid. [**Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Monetary defaults and reinstatement

A trust deed on which a foreclosure has been initiated is considered reinstated when the beneficiary receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes, insurance, assessments, and advances;
- installments that become due and remain unpaid after the recording of the NOD, and any future advances made by the beneficiary after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums, and to eliminate any other impairment of the security; and

Figure 1



- costs and expenses incurred by the lender to enforce the trust deed, including trustees fee's or attorney fees. [CC §2924c(a)(1)]

After an NOD is recorded, an owner or junior lienholder of an interest in the real estate in foreclosure can bring current any monetary or curable default stated in the NOD prior to five business days before the trustee's sale, called the *reinstatement period*. If the sale is postponed, the reinstatement period is extended, ending the day before the five business days prior to the postponed sale date. [See Figure 1; CC §2924c(e)]

Until the NOD is recorded by a trustee, the tender of all delinquencies must be accepted by the beneficiary.

After recording the NOD, the lender's trustee must allow three months (not 90 days) to pass before advertising and posting notice of the date of the trustee's sale. [CC §2924; see Figure 1]

The lender's trustee must begin advertising and post a Notice of Trustees Sale (NOTS) – and any other related notices – at least 20 days before the date of the sale. The property can be sold by the trustee no sooner than the twenty-first day after advertising begins and the posting of notice occurs. [CC §2924f(b); see Figure 1]

Additionally, if the billing address for the borrower is different than the address of the residential property in foreclosure, the NOTS must be accompanied by a notice to the occupants regarding their rights during and after foreclosure. [CC §2924.8]

The owner in foreclosure is not allowed to delay the trustee's sale by requesting a postponement. [CC §2924g]

Thus, the owner, or junior lienholder, has a minimum of approximately 105 days after the recording of the NOD to cure the default and reinstate the note and trust deed to avoid a full payoff or foreclosure sale of the property.

To determine the last day for reinstatement of the note and trust deed, consider a trustee's sale that is scheduled for a Friday. Count back five business days beginning with the first business day prior to the scheduled Friday sale. Since weekends are not business days, the fifth day counting backward from the scheduled trustee's sale is the previous Friday (if no holidays exist).

Thus, the very last day to reinstate the loan is on the Thursday eight calendar days before the trustee's sale.

The lender's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the lender can enforce payment of any omitted defaults by recording another, separate NOD. [CC §2924]

On reinstatement of the note and trust deed, the NOD is rescinded by the trustee, removing the recorded default from the title of the property. [CC §2924c(a)(2)]

The owner's alternatives

Aside from reinstatement and redemption, an owner of property has several other options when faced with losing his property through foreclosure:

1. *Refinance* — The owner obtains a new loan to pay off the one in default.
2. *Foreclosure consultant* — The owner seeks the services of a financial advisor or investment counselor, called a **foreclosure consultant**. For a fee, a foreclosure consultant will:
   - prevent a lender from enforcing or accelerating the note;
   - help the owner reinstate the loan or receive an extension of the reinstatement period; or
   - arrange a loan or an advance of funds for the owner. [CC §2945.1(a)]

   However, a property owner grappling with foreclosure can obtain similar services at no cost from a *mortgage counselor* subsidized by the federal government.
3. *Deed-in-lieu* — The owner deeds the property directly to the lender in exchange for cancelling the secured debt.
4. *Litigate* — The owner disputes the validity of the foreclosure by filing an action, restraining and enjoining the foreclosure.
5. *Bankruptcy* — The owner files for bankruptcy protection which automatically stays the foreclosure until a release of the stay is obtained by the lender from the court. [11 United States Code §362(a)]

   Unless the owner can make up the default or have the loan amount "crammed down" as part of the reorganization plan, bankruptcy only delays the inevitable foreclosure. Once the automatic stay is lifted, the foreclosure sale may take place no sooner than seven calendar days later. [CC §2924g(d)]
6. *Sale* — The owner sells the property before the trustee's sale.

   A recorded notice of default (NOD) must state the owner has the right to sell his property which in foreclosure. [CC §2924c(b)]

   In an effort to protect owners from being unlawfully deprived of the equity in their property when selling the property during the foreclosure period, special requirements exist for purchase agreements between owners and **equity purchase investors** on owner-occupied, one-to-four unit residential property in foreclosure. [CC §1695 et seq; see Chapter 71]

   However, selling property in foreclosure is difficult for the owner, due to time constraints and the difficulty of finding a buyer able to meet the financing needs to assume existing loans, cure defaults and correct the deferred maintenance on the property.
7. *Walk* — The owner simply vacates the property when the lender completes foreclosure.

   This is an economically viable alternative for an owner with little or no cash investment in the property, especially if payments saved during continued occupancy exceed the cash invested and the loan balance exceeds the property's value.

Any call is eliminated and the loan is returned to installment status when the note and trust deed have been reinstated. Upon reinstatement, the owner continues his ownership of the property as though the loan had never been in default.

Redemption

Failure to cure a default before the reinstatement period expires allows a trust deed holder to require the owner to redeem the property and avoid the trustee's sale by:

- paying all sums due under the note and trust deed; and
- reimbursing the costs of foreclosure prior to completion of the trustee's sale.

The owner's right of redemption exists until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property may satisfy the debt and redeem the property prior to the completion of the trustee's sale. [CC §2903]

To redeem the property, the owner or junior lienholder is required to pay the principal and all interest charges accrued on the principal, permissible penalties, foreclosure costs, and any future advances made by the foreclosing lender to protect his security interest in the property.

Unless all amounts due on the note and trust deed resulting from the owner's default are paid in full during the redemption period, the owner will lose the property at the trustee's foreclosure sale.

Lender remedies on a default

An owner's default on a trust deed loan encumbering his property can arise under a provision in either the note or the trust deed. A default on the note triggers a default on the trust deed, permitting foreclosure.

When the owner fails to pay installments of principal and interest as they become due under the terms of the note, he is then in **default** on the note. Thus, a default also exists on the trust deed.

The owner's default prompts the trust deed noteholder to immediately call the loan due under the **acceleration clause** in the note and trust deed by recording a NOD that initiates a trustee's foreclosure sale.

Additionally, when the owner fails to meet his obligations regarding the care, use, and maintenance of the secured real estate, he is in default under the *waste provision* in the trust deed. The default on the trust deed exists even though the owner may be current on all payments and the note is not in default.

The owner's failure to pay property taxes, hazard insurance premiums, assessments, and amounts due on senior trust deed liens is considered a default on the trust deed.

A trust deed noteholder may advance funds to cure a default on the trust deed, such as the owner's failure to pay hazard insurance premiums, and then add the advance to the debt owed by authority of the trust deed's **future advances** provision. The trust deed noteholder may then demand the immediate repayment of the advance from the owner.

Trust deed defaults and reinstatement

A property owner's ability to **reinstate** a loan by curing a default under a trust deed provision relating to the property and its title depends on the trust deed provision in default.

For example, an owner of real estate encumbered by a trust deed fails to pay property taxes or keep other senior liens on the property current. The trust deed lender records an NOD, describing the delinquent property taxes and other senior liens as the owner's default under the trust deed.

Can the property owner reinstate the loan and retain the property by eliminating the default?

Yes! The default is monetary, entitling the owner to reinstate the loan by simply paying the delinquent property taxes and payments on the senior lien, and the trustee's fees and charges incurred in the foreclosure proceeding.

Also, monetary defaults on trust deed provisions, such as the owner's failure to pay assessments, ground lease rent, senior encumbrances, hazard insurance premiums, or to obtain a hazard insurance policy, may be cured and the loan reinstated on the owner's tender of the full dollar amount of the default. [CC §2924c]

Defaults cured only by redemption

Some trust deed defaults do not allow an installment debt to be reinstated. Reinstatement of the note on those defaults is only available if agreed to by the lender. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt include a breach of a due-on clause, a waste provision, or a violation of law provision in the use of the property.

Consider real estate that is encumbered by a trust deed that requires the owner to maintain his property in good condition and repair. The owner fails to repair the aging improvements on his property and allows the trees and lawn to die.

The trust deed lender becomes concerned since the owner's activities causing waste have decreased the value of his security, called *impairment*. Due to the owner's failure to maintain the property in good condition (and thus the loan-to-value ratio due to a reduced property value), the lender records an NOD against the property.

Unlike a failure to maintain hazard insurance, here the owner cannot cure the default in the trust deed (waste) by tendering less than the entire remaining balance of the debt. Thus, the owner is unable to reinstate the loan. As a result, the entire foreclosure period becomes the redemption period.

To retain ownership of the property after the loan had been called due to waste, the owner must **redeem** the property by tendering full payment of all sums due, including foreclosure costs, prior to the trustee's sale.

Alternatively, the trust deed gives the lender the authority to cure the waste and add that cost to the principal balance of the note under the future advances clause.

However, when waste by the owner is committed in bad faith, the foreclosing lender must consider an underbid in a dollar amount equal to the property's reduced fair market value should the lender acquire the property at the trustee's sale.

With an underbid, the lender can sue the owner to recover the deficient property value below the amount due, which was caused by the bad faith waste, even if the note is a nonrecourse debt. [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590]

Chapter 71 — Judicial foreclosure

This chapter outlines the judicial foreclosure process, and presents the rights exercisable by property owners and junior lienholders before and after a judicial foreclosure sale.

For a further discussion of this topic, see Chapter 46 of Real Estate Finance.

Chapter 71 Outline

Deficient property value; recourse paper
Suing to foreclose
Reinstatement
The foreclosure decree
Notice of Levy
Highest bidder acquires the property
Judicial sale completed
Redemption follows foreclosure
Obtaining a deficiency judgment
The formula for a deficiency
The fair price

Chapter 71 Terms

Exhaust the security	*Litigation guarantee*
Fair market value	*Nonjudicial foreclosure*
Judicial foreclosure	*Recourse debt*
Notice of levy	*Reinstatement period*
Probate referee	*Right of redemption*
Lis pendens	*Successor-in-interest*

Deficient property value; recourse paper

When a trust deed note is in default, the trust deed lender's **collection efforts** are limited to two activities: judicial or non-judicial, both of which are very structured. If the note evidences a **recourse debt**, the lender may elect to recover against both the property and the borrower or just the property.

To initiate either type of collection effort, a trust deed lender must first *exhaust the security* by foreclosing on the real estate described in the trust deed lien. The lender's security interest in a property is exhausted when the lender **forecloses** on the property or when the lender's trust deed is **wiped out** by a senior trust deed holder's foreclosure.

Only when the note evidences a **recourse debt** may the lender pursue a money judgment against the signers on the note for any deficiency in the property's value to fully satisfy the debt owed. [Calif. Code of Civil Procedure §726]

Foreclosure is an activity comprised of notices and an auction to sell real estate to satisfy a debt secured by the security interest held in the property by the lender. Foreclosure of the property eliminates the *right of redemption* held by the owner and any persons holding junior interests in the property.

A trust deed holder can **foreclose** on a property, which is the security for a note, in one of two ways:

- *judicial foreclosure*, under mortgage law, also called a *sheriff's sale* [CCP §725a]; or
- *nonjudicial foreclosure*, under the power-of-sale provision in the trust deed, also called a *trustee's sale*. [Calif. Civil Code §2924]

Judicial foreclosure is the court-ordered sale by public auction of the secured property. The process can last from eight months to multiple years before it is completed.

When a trust deed holder **nonjudicially forecloses** by a trustee's sale, the property is sold by private agreement at a public auction. Trustee's sales can be completed on property other than a one-to-four unit residential property within four months after a buyer defaults.

Unlike a judicial foreclosure sale, the completion of a trustee's sale denies the foreclosing lender the opportunity to obtain a money judgment for any unpaid balance remaining on the note after the foreclosure sale due to an *underbid* and *insufficient value* in the secured property. [CCP §580d]

Trustee's sales are considerably less expensive than judicial foreclosures, both in time and money. A judicial sale requires the filing of a lawsuit which includes litigation expenses, appraisals, attorney fees, and a greater length of time then would be required for a nonjudicial foreclosure.

However, when the value of a secured property drops below the balance owed on a *recourse debt*, the lender must consider foreclosing by judicial action, whether or not he ultimately chooses to do so.

A judicial foreclosure, or sheriff's sale, is the only foreclosure method which allows a lender to obtain a money judgment against the borrower for any deficiency in the value of the secured property to fully satisfy a recourse debt. [CCP §580d]

Suing to foreclose

As with any lawsuit, the first step in a judicial foreclosure is the filing of a complaint in the Superior Court of the county where the property is located.

The foreclosure complaint must name as defendants the **original borrower** and anyone else holding a recorded interest in the secured property which is junior to the foreclosing lender's

trust deed lien. The trustee named in the trust deed does not need to be involved in the lawsuit in any way. A trustee under a trust deed has no interest in the property, is unconcerned wit hthe judicial foreclosure, and thus it is not necessary for him to be involved in the judicial proceedings.

The lender foreclosing judicially must obtain a *litigation guarantee* of title insurance. The policy is comparable to a trustee's guarantee ordered out to assist a foreclosure trustee in the notice process.leading to the auction sale of the property.

The **litigation guarantee** lists all parties with a recorded interest in the property and their addresses of record. The litigation guarantee ensures that persons with a recorded junior interest in the property are named and served, so their interest is eliminated from title by the judicial foreclosure sale.

If a person holding an interest in the propert junior to the lender's trust deed is not named as a defendant:

- his lien is not affected by the outcome of the foreclosure proceedings; and
- his lien on the property being foreclosed remains of record. [CCP §726(c)]

Additionally, when the foreclosing lender intends to seek a deficiency judgment, the original borrowers must be named as defendants, whether or not the borrowers still hold an interest in the property. [**Hutchison** v. **Barr** (1920) 183 C 182]

At the time the lawsuit is filed, the foreclosing lender records a **Notice of Pending Action** against the secured property, called a *lis pendens*.

The **lis pendens** places a cloud on the title of the secured property, giving notice of the judicial foreclosure action and subjecting later acquired interests by buyers, tenants or lenders to the results of the litigation without their being named or served with a lawsuit.

Reinstatement

Until the court enters a judgment ordering the sale of the secured property, called a *foreclosure decree*, the borrower has the right to bring the delinquencies in the note and trust deed current. A foreclosure decree brings to an end the period of time called the *reinstatement period*.

The borrower or any holder of an interest in the property junior to the foreclosing lender's security interest may **reinstate** the loan prior to the foreclosure decree by tendering payment of:

- the loan delinquencies;
- accrued interest; and
- the lender's foreclosure costs such as litigation expenses. [CC §2924c]

If the borrower reinstates the delinquent debt, a right enforceable until the court's entry of the foreclosure decree, the lender must abandon its foreclosure attempt and dismiss the lawsuit.

Attorney fees due on a reinstatement are limited in amount by statute.

The foreclosure decree

A lender judicially foreclosing on real estate establishes its right to collect the debt and sell the secured property by obtaining a *foreclosure decree* at a summary judgment proceeding or a trial.

A **foreclosure decree** orders the sale of the real estate to satisfy the outstanding debt and cover foreclosure sale expenses incurred by the lender. [CCP § 726(a), (b)]

The foreclosure decree also states whether the borrower will be held personally liable for any deficiency in the property's fair market value to satisfy the debt owed. [CCP §726(b)]

Notice of Levy

A judicial foreclosure sale is conducted by a court-appointed receiver or sheriff, called a *levying officer*.

After the judicial foreclosure sale is ordered by the court, the foreclosing lender is issued a *writ of sale* by the court clerk which authorizes the receiver or sheriff to record a *notice of levy*. The **writ of sale** and the **notice of levy** describes the property to be sold and states the levy is against the security interest the lender holds in the property under his trust deed lien. [CCP §712.010]

The receiver or sheriff who conducts the sale **records** the writ of sale and the notice of levy in the county in which the property is located. [CCP §700.015(a)]

The receiver or sheriff also mails to the owner, and serves on any occupant of the property, the writ of sale and the notice of levy. [CCP §700.010]

The notice of judicial sale

Similar to the notice of trustee's sale used in a nonjudicial foreclosure, the receiver's or sheriff's notice of sale must state the necessary details as to the date, time and location of the auction sale. [CCP §701.540(a)]

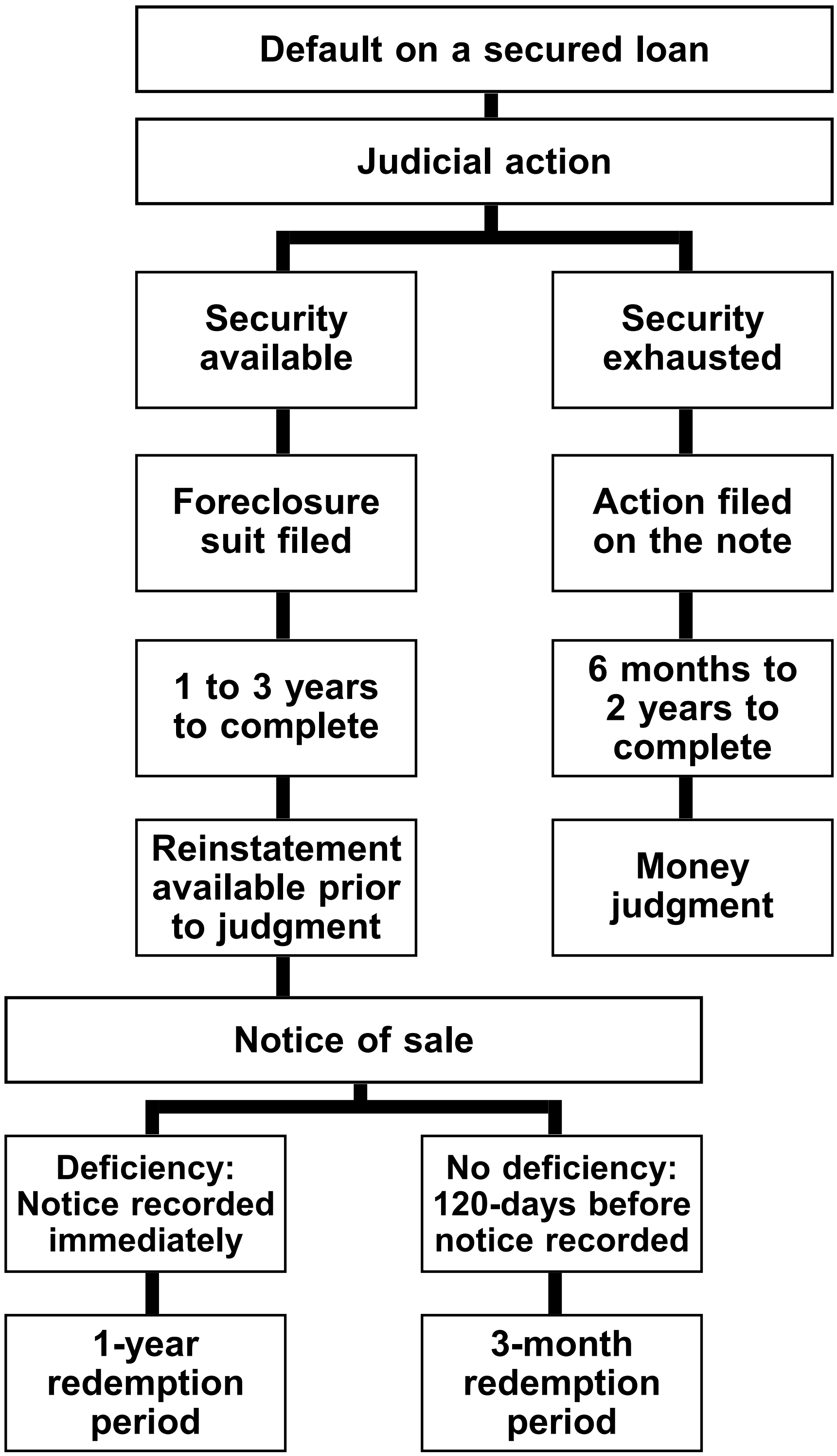
When a deficiency judgment is sought by a lender, the notice of judicial sale also states:

- the property is being sold subject to the borrower's right of redemption; and

- the amount of the secured debt, plus accrued interest and foreclosure costs. [CCP §729.010(b)(1)]

If a money judgment for any deficiency is prohibited, as occurs with a non-recourse debt, the receiver or sheriff must wait at least 120 days after service of the notice of levy before he may notice the judicial sale. [CCP §701.545]

Collecting a recourse debt



However, if the lender seeks a deficiency judgment, no waiting period applies for noticing the sale. The receiver or sheriff may notice the judicial sale immediately after the decree is issued. [CCP §729.010(b)(2), (3)]

At least 20 days before the sale, the notice of judicial sale is:

- served on the borrower personally or by mail [CCP §701.540(c)];
- mailed to any person who has recorded a request for a notice of judicial sale [CCP §701.550(a)];
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published weekly in a local newspaper of general circulation. [CCP §701.540(g)]

Highest bidder acquires the property

The public sale held by a court-appointed receiver or sheriff is conducted as an auction. The property is **sold to the highest bidder**. [CCP §701.570]

Payment at the public sale must be made in cash or by certified check at the time of the sale. However, amounts over $5,000 permit a credit transaction. [CCP §701.590(a), (c)]

If the successful bidder fails to pay the amount bid, the receiver may sell the property to the highest bidder at a subsequent sale. The defaulting bidder is liable for interest, costs and legal fees for his failure to pay his bid. [CCP §701.600]

Often, the foreclosing lender is the highest, or only, bidder at a judicial sale. When intending to seek a deficiency judgment, the lender must **bid no less** than an amount it believes the court will set as the *fair market value* (FMV) of the property. If he allows the property to be bid in at the sale for less than its FMV, the lender incurs an uncollectible loss for the difference. [**Luther Burbank Savings & Loan Assn.** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

Judicial sale completed

A *certificate of sale* is issued to the successful bidder on the completion of a judicial sale.

Although the bidder purchased the property at the public auction, he will not become the owner of the property or be able to take possession of it by removing the owner until the applicable **redemption period** expires. [CCP §729.090]

The **certificate of sale** reflects the owner's continuing right to redeem the property and avoid losing it to the highest bidder. [CCP §729.020]

Redemption follows foreclosure

On a judicial foreclosure, a trust deed which secures a seller carryback note as a lien solely on the property sold, or a lender's purchase-assist loan as a lien on a buyer-occupied, one-to-four unit residence, the property owner:

- is not liable for any deficiency in the property value to fully satisfy the debt [CCP §580b]; and

- has **three months** after the judicial sale to redeem the property by paying off the entire debt and costs. [CCP §729.030]

However, if the owner is liable on a recourse debt for a deficiency in the property's value, the owner has up to **one year** after the judicial sale to redeem the property. [CCP §729.030]

The property can only be redeemed by the owner or the owner's *successor-in-interest* since all junior lienholders are wiped out by the judicial foreclosure sale, ending their period for redemption.

Successors-in-interest to the owner are lienholders or buyers who acquire the owner's interest in the property by deed prior to the judicial foreclosure sale. [CCP §729.020; 15 Calif. Law Revision Commission Reports 2001]

The **redemption price** for the owner (or successor) to recover the property sold at a judicial foreclosure sale is the total of:

- the price paid for the property by the highest bid at the judicial foreclosure sale;

- taxes, assessments, insurance premiums, upkeep, repair or improvements to the property paid by the successful bidder; and

- interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full. [CCP §729.060]

On **redemption**, the owner or his successor is entitled to:

- an offset for any net rents collected by the lender under an **assignment of rents provision** in the trust deed; and

- an offset for the rental value of the premises for any period of time the successful bidder occupied the property following the sale. [CCP §§729.060, 729.090]

If the property is not redeemed by the owner or his successor-in-interest within the owner's redemption period, the receiver issues the bidder a *sheriff's deed* to the property, and the sale is final. [CCP §729.080]

Obtaining a deficiency judgment

The remaining balance owed on a note may be greater than the *fair price* of the lender's security interest in the real estate. The spread when the fair price is higher is the *deficiency* in the value of the property to cover the debt. The **fair price** of the lender's position in title is based on the value of the property at the time of the judicial foreclosure sale.

A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by anti-deficiency statutes. The lender will be awarded a money judgment for any deficiency in value at a hearing following the foreclosure sale. At the post-foreclosure hearing, the amount of the deficiency is set by the court — the difference between the fair price of the lender's security interest in the property on the date of the judicial foreclosure sale and the amount of the debt — called a *fair value hearing*. [CCP §§580a, 580b]

A **fair value hearing**, noticed within three months after the foreclosure sale, will set the dollar amount awarded as a deficiency judgment. [CCP §§580a, 726(b)]

The amount awarded as a deficiency judgment is based on the debt owed under the note and trust deed on the date of the judicial foreclosure sale, and the greater of:

- the FMV of the property on the date of the foreclosure sale, minus any amounts owed on liens senior to the trust deed being foreclosed, the result setting the *fair price* of the lender's security interest; or
- the amount **bid** for the property at the judicial foreclosure sale. [CCP §580a]

The lender will be awarded a money judgment for the portion of the debt not covered by the fair price of the lender's secured position on title or the price bid at the sale, which ever amount is higher.

The lender and the borrower present evidence at the fair value hearing to establish the property's FMV. The court may appoint an appraiser, called a *probate referee*, to advise the court on the property's FMV. Thus, evidence consists of the opinions of appraisers (and the owner) about the FMV of the property on the date of the sale. [CCP §§580a, 726(b)]

The formula for a deficiency

The **correct formula** for calculating the deficiency (always a negative amount): **Enter** the FMV of the property, **subtract** both the unpaid tax liens and any other prior liens and the remaining debt owed the foreclosing lender. The result, if negative, is the amount of the deficiency awarded to the lender.

The fair price

A deficiency judgment is awarded to a lender based on the **unencumbered full cash value** of the secured property, a value which is set consistent with current market conditions on the date of the foreclosure sale, called *fair market value* (FMV). [CCP §726]

Clouds on title, such as a junior lien or a lis pendens, which are wiped out at a foreclosure sale do not affect the property's FMV. [**Nelson** v. **Orosco** (1981) 117 CA3d 73]

The FMV of property is set without concern for any negative impact the foreclosure sale may have had on the property's value, or the price a prudent buyer would have to pay at the foreclosure sale for the lender's security position on title. [**San Paolo U.S. Holding Company, Inc.** v. **816 South Figueroa Company** (1998) 62 CA4th 1010]

Once the FMV of the property is determined, the amount of the deficiency is determined by subtracting all prior lien amounts and the amount of the debt being foreclosed from the property's FMV.

If the amount remaining is negative, the lender is awarded a deficiency judgment for that negative amount. Thus, any underbid below the fair price for the lender's position in the property results in a loss for the lender.

The amount of the difference between the fair price of the lender's position and the underbid is not recoverable in either the deficiency judgment or on redemption by the owner.

Chapter 72 — Trustee's foreclosure procedures

This chapter discusses a trustee's statutory duties for publicly conducting a privately agreed-to foreclosure sale of real estate.

For a further discussion of this topic, see Chapter 47 of Real Estate Finance.

Chapter 72 Outline

Power-of-sale provision
Who conducts the sale
Pre-foreclosure workout prior to NOD
The stages of foreclosure
Trustee's sale guarantee
The notice of default and election to sell
Delivering the NOD
Proof of service required for mailing
The notice of trustee's sale
The NOD and NOTS in Spanish
Delivering the NOTS
The location of the sale
Sold to the highest bidder
Failure to deliver payment of a bid
Bids by the beneficiary
Conveyance by a trustee's deed

Chapter 72 Terms

Beneficiary	*Notice of trustee's sale*
Bona fide purchaser	*Power-of-sale provision*
Constructive notice	*Redemption period*
Full credit bid	*Reinstatement period*
Judicial foreclosure sale	*Trustee's sale*
Nonjudicial foreclosure sale	*Trustor*
Notice of rescission	*Sheriff's sale*

Power-of-sale provision

A lender or carryback seller holding a note secured by a trust deed which is in default has **two foreclosure methods** available to enforce collection of the secured debt:

- a *judicial foreclosure sale*, also called a *sheriff's sale* [Calif. Code of Civil Procedure §726]; or

- a *nonjudicial foreclosure sale*, also called a *trustee's sale*. [Calif. Civil Code §2924]

The key to the trust deed holder's ability to **nonjudicially foreclose** by a trustee's sale on the secured real estate is the *power-of-sale authority* and *power-of-sale provision* contained in the trust deed. [See Figure 1]

Other security devices used to create a lien on real estate to secure a debt which may also contain a **power-of-sale provision** include:

- a land sale contract [**Petersen** v. **Hartell** (1985) 40 C3d 102; see **first tuesday** Form 168 §15];
- a lease-option sale [See **first tuesday** Form 163 §19];
- a UCC-1 financing statement [**Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25]; or
- the *conditions, covenants and restrictions (CC&Rs)* of an association for collection of assessments. [CC §1367]

The grant of the power-of-sale provides a private contract remedy for the **recovery of money**, voluntarily agreed to by the owner of the secured property, authorizing the secured creditor on a default in the trust deed to hold a nonjudicial foreclosure sale by public auction, called a *trustee's sale*. [CC §2924]

The lender, carryback seller, homeowners association or other holder of a lien on the real estate with a power-of-sale provision or statutory authority typically forecloses by a trustee's sale.

However, if the secured note evidences a recourse debt with a remaining balance exceeding the *fair price* of the lender's position as the holder of a security interest in the real estate described in the trust deed, the lender may choose a judicial foreclosure and seek a money judgment for any deficiency in the property's value to satisfy the debt. [See Chapter 71]

Figure 1

*Excerpted from **first tuesday** Form 450—*
Long Form Trust Deed and Assignment of Rents

GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE

3.6. TRUSTEE'S SALE — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with California Civil Code Sec. 2924 et seq.

Scan this QR-Code for a PDF of the Form!

Figure 2

first tuesday *Form 471 -*
Notice of Default - With Substitution of Trustee (California Civil Code §2924c)

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF DEFAULT
with SUBSTITUTION OF TRUSTEE
(California Civil Code §2924c)

Prepared by: Agent ________________ Phone________________________
Broker ________________ Email________________________

IMPORTANT NOTICE

IF YOUR PROPERTY IS IN FORECLOSURE BECAUSE YOU ARE BEHIND IN YOUR PAYMENTS, IT MAY BE SOLD WITHOUT ANY COURT ACTION, and you may have the legal right to bring your account in good standing by paying all of your past due payments plus permitted costs and expenses within the time permitted by law for reinstatement of your account, which is normally five business days prior to the date set for the sale of your property. No sale date may be set until three months from the date this notice of default may be recorded (which date of recordation appears on this notice).

This amount is $__________________ as of ____________, 20______, and will increase until your account becomes current.

While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing. In addition, the beneficiary or mortgagee may require as a condition to reinstatement that you provide reliable written evidence that you paid all senior liens, property taxes, and hazard insurance premiums.

Upon your written request, the beneficiary or mortgagee will give you a written itemization of the entire amount you must pay. You may not have to pay the entire unpaid portion of your account, even though full payment was demanded, but you must pay all amounts in default at the time payment is made. However, you and your beneficiary or mortgagee may mutually agree in writing prior to the time the notice of sale is posted (which may not be earlier than the end of the three-month period stated above) to, among other things, (1) provide additional time in which to cure the default by transfer of the property or otherwise; or (2) establish a schedule of payments in order to cure your default; or both (1) and (2).

Following the expiration of the time period referred to in the first paragraph of this notice, unless the obligation being foreclosed upon or a separate written agreement between you and your creditor permits a longer period, you have only the legal right to stop the sale of your property by paying the entire amount demanded by your creditor.

PAGE ONE OF THREE — FORM 471

PAGE TWO OF THREE — FORM 471

To find out the amount you must pay, or to arrange for payment to stop the foreclosure, or if your property is in foreclosure for any other reason, contact:

____
(Name of Beneficiary or Mortgagee)
____
(Mailing address)
____
(Telephone)

Pursuant to California Civil Code §2923.5, Beneficiary:

- ☐ **has contacted Owner and discussed avenues for refinance.**
- ☐ **is unable to contact Owner after a due diligence effort.**
- ☐ **is not required to contact Owner since Beneficiary's record does not show the trust deed is secured by an owner-occupied, one-to-four unit primary residence.**

If you have any questions, you should contact a lawyer or the governmental agency which may have insured your loan.

Notwithstanding the fact that your property is in foreclosure, you may offer your property for sale, provided the sale is concluded prior to the conclusion of the foreclosure.

Remember, YOU MAY LOSE LEGAL RIGHTS IF YOU DO NOT TAKE PROMPT ACTION.

NOTICE IS HEREBY GIVEN:

A Deed of Trust dated ________________________________ executed by ____, as the Trustor, in favor of ______________________________________, as the Beneficiary, recorded on ________________________ , as Instrument No. ____________, of Official Records in the office of the County Recorder of ___________County, California, secures, among other obligations, ______ note(s) in the original amount of $________________.

The beneficial interest under the Deed of Trust is held by the undersigned Beneficiary who HEREBY appoints ____ as Trustee under the Deed of Trust.

A default in the obligations secured by the Deed of Trust has occurred in that payment has not been made of:

____
____
____
____
____.

PAGE TWO OF THREE — FORM 471

PAGE THREE OF THREE — FORM 471

Due to the default, the undersigned Beneficiary has signed and delivered to the Trustee a written Declaration of Default and Demand for Sale, and has deposited with the Trustee the Deed of Trust and all documents evidencing the secured obligations, and hereby declares all sums of the secured obligations immediately due and payable and elects to cause the real estate encumbered by the Deed of Trust to be sold to satisfy the secured obligations.

____
(Signature of Beneficiary)

STATE OF CALIFORNIA
COUNTY OF________________________________
On ________________________________ before me,
____
(Name and title of officer)
personally appeared ____________________________
____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ________________________________
(Signature of notary public)

(This area for official notarial seal)

FORM 471 03-11

Scan this QR-Code for a PDF of the Form!

By foreclosing under the power-of-sale provision, the holder of a lien on real estate avoids a costly court action for judicial foreclosure should the owner default on the trust deed.

Editor's note — When a lender completes a foreclosure by trustee's sale, it cannot then obtain a deficiency judgment against the owner of the secured real estate. On the other hand, the owner cannot redeem the property after the lender's trustee's sale as he can after a judicial foreclosure sale.

Who conducts the sale

A trust deed is a **security device** which by agreement imposes a lien on real estate. It creates a **fictional trust** to "hold title" to the secured real estate for the benefit of the lienholder. Thus, a trust deed has three parties:

- at least one *trustor* (the owner(s) of the secured real estate);
- a *trustee* who need not be named; and
- at least one *beneficiary* (a lender, carryback seller, common interest association or other lienholder).

The trustee's sale is conducted by the **trustee** who is either:

- named in the trust deed; or
- appointed by the beneficiary of the trust deed at the time the beneficiary initiates the foreclosure process.

A broker, attorney, trust deed service, subsidiary of the lender, or the lender itself may be appointed as the trustee. The trustee named in the trust deed, unless replaced by recording a substitution naming another trustee, may process the foreclosure. The trustee begins foreclosure by recording a notice of default (NOD) and ends the process on delivery of the trustee's deed and disbursement of any sales proceeds. [**Bank of America National Trust & Savings Association** v. **Century Land & Water Co.** (1937) 19 CA2d 194; see Figure 2]

Generally, trust deeds prepared and distributed by title or escrow companies name their company as the trustee. However, a trust deed or other security device **need not name** the trustee at all. The beneficiary then simply appoints a trustee to handle the NOD or reconveyance. [See **first tuesday** Form 450]

Also, the beneficiary may appoint a substitute trustee to replace a named trustee for various reasons, such as:

- the named trustee no longer exists;
- the named trustee is uncooperative; or

- the beneficiary simply wants to use a different trustee for any reason. [CC §2934a]

Pre-foreclosure workout prior to NOD

Before recording an NOD on a trust deed securing a purchase-assist loan as a lien on residential property intended to be the borrower's principal residence, which was recorded during the period of 2003 through 2007, a lender must conduct or attempt to conduct a pre-foreclosure workout with the owner.

By at least 30 days prior to recording an NOD on one of these owner-occupied SFR loans, the lender must have made an initial contact, or attempt to contact, with the borrower to:

- assess the borrower's financial situation;
- explore options for the borrower to avoid foreclosure;
- advise the borrower of his right to an additional meeting within 14 days to discuss his financial options;
- provide borrowers with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency; and
- in the event personal or phone contact cannot be made, the lender must exercise due diligence through further attempts to contact the borrower, including:
    - sending a letter via first-class mail to the borrower/owner containing HUD's toll-free number used to find and contact a HUD-certified counseling agency;
    - after sending the letter, the lender may employ an automated dialing system to telephone the borrower on at least three different days and at different hours, provided a live representative is available if the borrower answers the call; and
    - make at least three attempts to reach the borrower by phone, unless the lender determines all the borrower's telephone numbers on file have been disconnected.

If the lender is unable to make contact with the borrower by these methods, the lender must send the borrower a certified letter, return receipt requested, containing a toll-free number with access to a representative during business hours.

When contacting an owner whose principal residential loan is in default:

- a lender's loss mitigation personnel may participate in any telephonic communication;
- the borrower may select a HUD-certified agent to represent him during any meeting with a lender to discuss ways of avoiding foreclosure; and

- any loan modification or plan to avoid foreclosure offered by the lender is subject to the borrower's approval.

The lender may record an NOD on a loan without complying with any of these 30-day pre-foreclosure requirements when the borrower has:

- surrendered the property to the lender either by letter confirming the surrender or by delivery of the keys to the lending institution;
- contracted with a person who facilitates a borrower's decision to leave their home by extending the foreclosure process and avoiding the lender's enforcement of the loan; or
- filed a bankruptcy petition which is pending.

The NOD controlled by pre-foreclosure work-out rules must, when recorded, include a declaration stating:

- the lender succeeded in contacting the borrower according to the above guidelines;
- the lender was unable to contact the borrower, despite exhausting all due diligence efforts; or
- the borrower has surrendered the property to the lending institution.

To be **due-diligent** compliant, the lender must, before making the initial contact (or attempt to contact) with the borrower to commence the 30-day pre-foreclosure workout for recording the NOD, post a prominent link on the lender's website containing information, including:

- options available for a borrower who is unable to make his mortgage payment and wants to avoid foreclosure;
- a list of financial documents a borrower needs to have when discussing alternatives to foreclosure with the lender;
- a toll-free telephone number for a borrower to call to discuss alternatives to foreclosure with their lender; and
- the toll-free number made available by HUD for the borrower to find and contact a HUD-certified housing counseling agency. [CC §2923.5]

The stages of foreclosure

A trustee's actions under a **power-of-sale provision** are strictly controlled by California statutes. To successfully complete a trustee's foreclosure sale of the secured real estate, the trustee and

beneficiary of the trust deed must adhere to the procedures fully detailed in the foreclosure statutes for handling a trustee's sale. [**Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268]

For the trustee the foreclosure process and fees are broken down into three stages (after the **pre-foreclosure workout** has been attempted):

1. Recording and serving a notice of default (NOD);

2. Recording, posting and serving the notice of trustee's sale (NOTS); and

3. Conducting the sale of the real estate, which includes auctioning off the property, executing the trustee's deed and distributing any sales proceeds.

In contrast to the three stages for the trustee's processing of the foreclosure, the owner of the real estate and the beneficiary are concerned primarily with two different periods of time which control payment of the debt:

- the *reinstatement period*, which runs from the recording of the NOD and ends prior to five business days before the trustee's sale; and

- the *redemption period*, which also runs from the recording of the NOD but ends with the completion of the trustee's sale of the secured property. [See Chapter 70]

Trustee's sale guarantee

When a trust deed is in default and the beneficiary has chosen to foreclose on the property, the beneficiary delivers a **Declaration of Default and Demand for Sale** to the trustee. The declaration contains instructions directing the trustee to initiate foreclosure on the secured real estate as authorized under the power of sale granted in the trust deed. [See Figure 2]

Even though the trustee may have received the beneficiary's declaration of default, the trustee's foreclosure process does not begin and foreclosure fees are not incurred by the property owner until the trustee or beneficiary records a notice of default (NOD). [**System Investment Corporation** v. **Union Bank** (1971) 21 CA3d 137]

Once the NOD is recorded, the trustee must strictly follow statutory notice requirements. To be assured he serves all the required notices on the proper persons, the trustee orders out a *trustee's sale guarantee* from a title company before or at the time the NOD is recorded.

The trustee's sale guarantee provides **coverage** for the trustee should he fail to service notices on any party of record due to an omission in the guarantee.

The **trustee's sale guarantee** advises the trustee on:

- who must receive a copy of the NOD and notice of trustee's sale (NOTS) — the person(s) entitled to receive notice that the secured obligation is subject to a recorded notice of default (NOD) and the property will be sold nonjudicially at the trustees's sale; and

- the location of the secured real estate where a copy of the NOTS will be posted and in which newspapers the NOTS will be published.

Thus, the trustee's sale guarantee contains:

- the name and address of each person who has recorded a request for a copy of the NOD;
- the name and address of each party with a recorded interest in the real estate securing the obligation in default;
- any junior (later recorded) easements and to whom the easements were granted;
- the property's legal description;
- a plat map locating the property; and
- the names of the newspapers in general circulation in which the NOTS, and the NOD if necessary, are to be published.

Additionally, the trustee employs the title company as his agent to record documents, such as the NOD, NOTS, rescission of NOD and the trustee's deed.

The notice of default and election to sell

When ordering out a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to **record the notice of default** (NOD) in the office of the county recorder in the county or counties where the secured real estate is located. [CC §2924]

The NOD contains a statutorily mandated statement which sets forth the *monetary default* on the note or other obligation secured by the trust deed. [CC §2924c(b)(1)]

The **monetary default** statement informs the owner:

- he must continue to pay other obligations required of him by the trust deed, such as hazard insurance and property taxes; and
- if he does not make future payments on the obligations in default, the owner is required to make the payments to reinstate the loan. [See Figure 2]

The NOD does not need to state the actual amounts of the monetary defaults on the recurring obligations. However, the NOD must state the nature of the present defaults on the note and the trust deed, such as failure to have paid hazard insurance premiums and property taxes. [CC §2924c(a)(1)(B)]

Figure 3

first tuesday *Form 474 -*
Notice of Trustee's Sale

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF TRUSTEE'S SALE

Scan this QR-Code for a PDF of the Form!

IMPORTANT NOTICE

YOU ARE IN DEFAULT UNDER A ____________________________, DATED ______________. UNLESS YOU TAKE ACTION TO PROTECT YOUR PROPERTY, IT MAY BE SOLD AT A PUBLIC SALE. IF YOU NEED AN EXPLANATION OF THE NATURE OF THE PROCEEDING AGAINST YOU, YOU SHOULD CONTACT A LAWYER.

On _____________, 20______, at ____, California,
____,
as Trustee or Successor Trustee under a Trust Deed dated __________________, executed by
____, as the Trustor,
for the benefit and security of ____, as the Beneficiary,
recorded _____________________, as Instrument No. ___________________ in the records of the County Recorder,
County of ____, State of California.

YOUR PROPERTY MAY BE SOLD AT PUBLIC AUCTION TO THE HIGHEST BIDDER FOR CASH, A CASHIER'S CHECK DRAWN ON A STATE OR NATIONAL BANK, A STATE OR FEDERAL CREDIT UNION, OR A STATE OR FEDERAL SAVINGS AND LOAN ASSOCIATION/THRIFT DOMICILED IN THE STATE OF CALIFORNIA (payable at time of sale in lawful money of the United States) at ____
____,
all rights, title and interest conveyed to and now held by it under said Trust Deed in the property situated in said County and State referred to as:
____
____.

The street address and other common designation, if any, of the real property described above is purported to be:
____
____.

County assessor's parcel number ______________________________.

THE TRUSTEE DISCLAIMS ANY LIABILITY FOR INCORRECT INFORMATION FURNISHED.

The auction sale is made without covenant or warranty regarding title, possession or encumbrances, or as to insurability of title.

The total amount of the unpaid balance of said obligations together with advances, and estimated costs and expenses, is $________________.

The notice of breach of this obligation and election to sell said real property was recorded as Instrument No. ___________________________, on _____________, 20______, of Official Records in the office of the County Recorder of ____ County, State of California.

— — — — PAGE ONE OF TWO — FORM 474 — — — —

— — — — PAGE TWO OF TWO — FORM 474 — — — —

NOTICE TO PROPERTY OWNER:

The sale date shown on this notice of sale may be postponed one or more times by the mortgagee, beneficiary, trustee, or a court, pursuant to Section 2924g of the California Civil Code. The law requires that information about trustee sale postponements be made available to you and to the public, as a courtesy to those not present at the sale. If you wish to learn whether your sale date has been postponed, and, if applicable, the rescheduled time and date for the sale of this property, you may call ________________________ or visit this Internet Web site ____________________________, using the file number assigned to this case, _______________. Information about postponements that are very short in duration or that occur close in time to the scheduled sale may not immediately be reflected in the telephone information or on the Internet Web site. The best way to verify postponement information is to attend the scheduled sale.

NOTICE TO POTENTIAL BIDDERS:

If you are considering bidding on this property lien, you should understand that there are risks involved in bidding at a trustee auction. You will be bidding on a lien, not on the property itself.

Placing the highest bid at a trustee auction does not automatically entitle you to free and clear ownership of the property. You should also be aware that the lien being auctioned off may be a junior lien. If you are the highest bidder at the auction, you are or may be responsible for paying off all liens senior to the lien being auctioned off, before you can receive clear title to the property.

You are encouraged to investigate the existence, priority, and size of the outstanding liens that may exist on this property by contacting the county recorder's office or a title insurance company, either of which may charge you a fee for this information. If you consult either of these resources, you should be aware that the same lender may hold more than one mortgage or deed of trust on the property.

Date: _____________, 20______

Address: ______________________________________ Trustee: ______________________________________
____

Phone: ______________________________________ By: ______________________________________

Fax: ______________________________________ Title: ______________________________________

Email: ______________________________________

STATE OF CALIFORNIA
COUNTY OF____
On ____________________________________ before me,
____
(Name and title of officer)
personally appeared ________________________________
____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ____
(Signature of notary public)

(This area for official notarial seal)

FORM 474 12-11 ©2011 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Trustee's duties

A trustee under a trust deed has no fiduciary duty to either the noteholder or the property owner since the "trust" purportedly created by a trust deed is not an actual trust. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc**. (1989) 49 C3d 454]

A trustee under a trust deed has two duties owed to all involved, both of which are regulated by statute:

- *reconvey* the trust deed on satisfaction of the secured debt [CC §2941];
- exercise the *power of sale* on a default in the trust deed. [CC §2924 et seq.; Monterey, *supra*]

To determine the amount needed to cure the default, the NOD usually directs the owner or other interested persons seeking to reinstate the trust deed or redeem the property to contact the trustee by listing the trustee's name, address and telephone number after the beneficiary's name on the NOD.

Thus, the trustee insulates the beneficiary from all direct contact with the owner or junior lienholder during the foreclosure process.

If the NOD does not list a default actually known to the beneficiary at the time of recording, the unnamed default does not need to be cured for the loan to be reinstated. [**In re Peters** (9th Cir. BAP 1995) 184 BR 799]

However, the beneficiary may later record a separate NOD to notice the omitted default, and pursue a separate foreclosure based on the omitted default. [CC §2924]

Delivering the NOD

Within 10 business days after recording a notice of default (NOD), **two copies** of the NOD are mailed to each:

- the owner of the property;
- the administrator of a deceased owner's estate; and
- each person who has recorded a request to receive a copy of the NOD. [**Estate of Yates** v. **West End Financial Corporation, Inc.** (1994) 25 CA4th 511; CC §2924b(b)(1)]

One copy of the NOD is sent by registered or certified mail, the other copy is sent by first-class mail. [CC §2924b(b)(1), (e)]

Within one month after recording the NOD, the trustee is required to send a copy of the NOD by registered or certified mail and another copy by first-class mail to holders of a **recorded interest** in the secured property, including:

NOTICE OF SALE

(California Civil Code §2924.8)

Prepared by: Agent ____________________	Phone ____________________
Broker ____________________	Email ____________________

NOTICE OF SALE
PURSUANT TO SECTION 2924.8 OF THE CIVIL CODE

Foreclosure process has begun on this property, which may affect your right to continue to live in this property. Twenty days or more after the date of this notice, this property may be sold at foreclosure. If you are renting this property, the new property owner may either give you a new lease or rental agreement or provide you with a 60-day eviction notice. However, other laws may prohibit an eviction in this circumstance or provide you with a longer notice before eviction. You may wish to contact a lawyer or your local legal aid or housing counseling agency to discuss any rights you may have.

出售公告
依据民法典第2924.8章

因本房产的赎进程序已经开始，这可能会影响您在此继续居住的权利。从本通知起的二十天后，本房产可能会被出售。如果你是租房户，新的房主可能给你新的出租协议,或通知您在60天内搬家。但有些法律可能禁止在此情况下的清房，或可为您提供更长的搬家期限。您可以与您的律师,您当地的法律援助或房屋咨询机构讨论您的有关权利。

매매 통고
민법 제 2924.8 항에 의거

이 건물에 대한 차압 절차가 시작되었으며, 그로 인해 귀하가 이 건물에서 계속해서 거주할 수 있는 권리에도 영향이 미칠 수 있습니다. 이 통고문의 날짜로부터 20일 혹은 그 후에, 이 건물은 차압 매매될 수 있습니다. 만약 귀하가 이 건물을 임차하고 있다면, 새로운 건물 소유주는 귀하와 새임대차 계약을 하거나 또는 60일 이내 퇴거하라는 통고를 할 수 있습니다. 그러나, 다른 법률들은 이런 상황에서의 퇴거를 금지하거나 또는 귀하에게 퇴거하기 전까지 연장된 기간의 통고를 하도록 할 수도 있습니다. 귀하의 권리에 대한 상담을 하기 위해 귀하는 변호사 또는 귀하가 있는 지역의 법률 구호 기관 혹은 주택 상담 기관에 연락할 수도 있습니다.

ANUNCIO DE VENTA
SEGÚN LA SECCIÓN 2924.8 DEL CÓDIGO CIVIL

El proceso de ejecución de hipoteca ha comenzado en esta propiedad, lo que puede afectar su derecho de vivir en esta propiedad. La propiedad puede ser vendida en ejecución de hipoteca veinte días o más después de la fecha de este aviso. Si usted está rentando esta propiedad, el nuevo dueño de la propiedad puede darle a usted un nuevo contrato de arrendamiento o alquiler o darle un aviso de desalojo de 60-días. Sin embargo, otras leyes tal vez puedan prohibir un desalojo en esta circunstancia o proveerle a usted un aviso de desalojo de más tiempo para que desaloje la propiedad. Tal vez usted desee comunicarse con un abogado o su ayuda legal de la localidad o agencia de consejería de vivienda para hablar de cualquier derecho que usted tal vez tenga.

PAUNAWA SA PAGBENTA
BATAY SA SEKSYON 2924.8 NG NILAGDAANG SIBIL

Ang proseso ng pagreremata ay nagsimula na sa pag-aaring ito, na kung saan ay maaaring makaapekto sa inyong karapatan na tuluyang manirahan sa pag-aaring nabanggit. Dalawampung araw o higit pa matapos ang petsang naisagawa ang paunawang ito, ang nasabing pag-aari ay maaari nang ibenta batay sa pagremata. Kung kayo ay nangungupahan sa pag-aaring ito, ang bagong may-ari ay maaaring magbigay ng bagong kasunduan sa paghiram o pagbenta o bigyan kayo ng kasulatan na paunawa na makalipat sa loob ng 60 na araw. Gayunpaman, maaaring ipagbawal ng ibang batas ang pagpapaalis sa pagkakataong ito o maaaring bigyan kayo ng mas mahabang panahon bago ang pagpapaalis. Minumungkahi kayong makipagbigay alam sa inyong abogado o lokal na katulong pang-legal o ahensiya ng payong pabahay upang pag-usapan ang alinmang karapatan na kayo ay mayroon.

THÔNG BÁO BÁN
THEO ĐIỀU 2924.8 BỘ LUẬT DÂN SỰ

Việc bắt đầu tịch thu tài sản này có thể ảnh hưởng đến quyền tiếp tục sinh sống của bạn tại đây. Bắt đầu từ hai mươi ngày trở đi sau thông báo, tài sản này có thể bị tịch thu để trả nợ. Nếu bạn đang mướn nhà tại đây, chủ tài sản mới sẽ gửi cho bạn cam kết mới về việc thuê hoặc mướn hoặc có thể sẽ gửi cho bạn thông báo rời khỏi nhà trong vòng 60 ngày. Tuy nhiên,một số luật khác có thể không cho phép việc yêu cầu rời khỏi nhà trong trường hợp này mà gửi cho bạn thông báo sớm hơn trước khi yêu cầu bạn rời đi. Bạn nên liên hệ với luật sư hoặc tổ chức giúp đỡ luật địa phương hoặc cơ sở tư vấn nhà để tham khảo những quyền bạn có.

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- the owner's successor-in-interest to the estate or any portion thereof (easements);
- any junior trust deed holder;
- the assignee of a junior trust deed;
- a buyer on a land sales contract;
- a lessee on a lease; and
- the state Office of the Controller, if a **Notice of Lien for Postponed Property Taxes** is recorded against the property. [CC §2924b(c)]

Any person interested in obtaining a copy of the NOD, and who is not listed in the statute as a person who is to automatically receive notice, must record a **request for NOD** to assure they will be notified of the default and sale, such as a request by a tenant under an unrecorded lease or a licensee with signs located on the property. [See **first tuesday** Form 412]

Proof of service required for mailing

A trustee or person depositing the notice of default (NOD) into the mail must prepare a proof of service form and include a copy of the form with the NOD in each mailing. [CC §2924b(e)]

The notice of trustee's sale

A trustee (or beneficiary) may begin noticing the date set for the sale of a property by foreclosure on the day following **three months after** the notice of default (NOD) is recorded. [CC §2924]

The date the sale will be held may be set for any business day, Monday through Friday, between the hours of 9 a.m. and 5 p.m. [CC §2924g(a)]

In general practice, a *date down* of the trustee's sale guarantee issued to the trustee is ordered out from the title company the day before or the day on which the title company, as instructed, records the notice of trustee's sale (NOTS).

The **date down** notifies the trustee of any interests recorded on the title to the property after the NOD is recorded. However, the trustee is not required to give notice of the impending trustee's sale to any person who recorded an interest in the property after the NOD was recorded. [CC §2924b(c)(1)]

The trustee prepares an NOTS which contains:

- the trustee's or his agent's name, street address and telephone number (or toll-fee number if located out of state);
- the street address or common designation of the secured property;

- the county assessor's parcel number of the secured property;
- the dollar amount of the debt in default, including reasonably estimated advances for hazard insurance premiums, property taxes due and foreclosure costs; and
- a statutory statement informing the owner he is in default. [CC §2924f; see Figure 3]

A copy of this tenant's rights notice must also be mailed at the time of posting as a letter addressed to the "Resident of property subject to foreclosure sale." [CC §2924.8; see Form 474-1 accompanying this chapter]

The NOD and NOTS in Spanish

If the loan secured by the trust deed was negotiated in Spanish, the trust deed may contain a request for a Spanish-language notice of default (NOD). The trustee is then obligated to serve the owner an NOD translated into Spanish. [CC §2924c(b)(1)]

Delivering the NOTS

At least **20 calendar days before** the date selected by a trustee to hold a trustee's sale, the trustee must send two copies of the notice of trustee's sale (NOTS) to each party the trustee previously sent the notice of default (NOD). [CC §2924b(c)(3)]

As with the NOD, one copy of the NOTS is sent by registered or certified mail, while the other is sent by first-class mail. [CC §2924b(b)(2), (e)]

To ensure the sale of the secured property at a public auction is properly advertised, the notice requirements for the NOTS are more comprehensive than the notice requirements for the NOD.

In addition to mailing the notice to all interested parties of record, the trustee must perform all of the following at least **20 calendar days** prior to the sale:

- **post a copy** of the NOTS in one public place in the city of the sale, or if the sale is not to be held in a city, the judicial district in which the property is to be sold;
- **post a copy** of the NOTS in a conspicuous place on the property to be sold (for example, a door if the property is a single family residence); and
- **start publishing a copy** of the NOTS once a week for three consecutive calendar weeks in a newspaper of general circulation in the city where the property is located (the name of the newspaper is provided by the title company in the trustee's sale guarantee.) [CC §2924f(b)(1)]

The location of the sale

A trustee's sale must be held in the county where the secured real estate is located. [CC §2924g(a)]

If the property or properties being foreclosed are located in two or more counties, the trustee's sale may take place in any one of the counties where the property, or a portion of the property, is located. [CC §2924g(b)]

For example, consider a trustee who is to conduct a foreclosure sale of two properties which secure the same debt by the same trust deed and are located in different counties.

The trustee can sell both properties at one sale, in either county the trustee chooses. Also, the trustee can hold the sale in any area of the chosen county.

Sold to the highest bidder

A trustee's sale is essentially a **public auction** by private agreement (the trust deed) where the property is sold to the highest bidder. [CC §2924h]

Before the actual trustee's sale begins, the trustee can:

- demand all prospective bidders to show evidence of their financial ability to pay as a precondition to recognizing their bids; and
- hold the prospective bidders' amounts to be bid. [CC §2924h(b)(1)]

A bidder can tender his bid amount in U.S. dollars in the form of:

- cash;
- a cashiers check drawn on a state or national bank;
- a check issued by a state or federal thrift, savings and loan association (S&L), savings bank or credit union; or
- a cash equivalent designated by the trustee in the notice of trustee's sale (NOTS), such as a money order. [CC §2924h(b)(1)]

Each bid made at a trustee's sale is an **irrevocable offer** to purchase the property. However, any subsequent higher bid cancels a prior bid. [CC §2924h(a)]

The trustee's sale is considered final and completed on the trustee's **acceptance** of the last and highest bid. [CC §2924h(c)]

Once the highest bid has been accepted by the trustee, the trustee can require the highest bidder to immediately deposit the full amount of the final bid with the trustee, if the trustee is not already holding all the bidders' funds. [CC §2924h(b)(2)]

If the highest bidder tenders payment by a check issued by a credit union or a thrift, the trustee can refrain from issuing the trustee's deed until the funds become available. [CC §2924h(c)]

Failure to deliver payment of a bid

If a high bidder tenders payment by check and the funds are not available for withdrawal:

- the trustee's sale is automatically **rescinded**; and
- the trustee will send the highest bidder a *notice of rescission* for failure of consideration, provided the trustee has the bidder's address. [CC §2924h(c)]

To hold a new trustee's sale auction, the trustee must set a new trustee's sale date and record, serve and publish a new NOTS, following all statutory requirements.

The highest bidder who fails to tender payment when demanded or cancels the check is liable to the trustee for all damages resulting from the **refusal to tender** payment, including court costs, reasonable attorney fees and the costs for recording and serving the new NOTS. [CC §2924h(d)]

Bids by the beneficiary

The beneficiary is frequently the only bidder, and thus the highest bidder, at a trustee's sale. The beneficiary may bid, without tendering funds, up to an amount equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses, called a *full credit bid*. [CC §2924h(b)]

If the beneficiary is the highest bidder under a **full credit bid**, the trustee retains possession of the beneficiary's note (or other evidence of the secured debt) in exchange for the trustee's deed to the property.

However, the beneficiary is not required to bid the full amount of the indebtedness to acquire the property at the trustee's sale. The beneficiary can bid an amount below the full amount of the debt, called an *underbid*.

Conveyance by a trustee's deed

On the completion of a trustee's sale, the trustee uses a *trustee's deed* to grant title to the property to the highest bidder.

When a buyer other than the beneficiary purchases the property at a trustee's sale for value and without notice of any title or trustee's sale defects, the buyer is considered a *bona fide purchaser* (BFP).

The **BFPs** interest in the property sold is *perfected* as of 8 a.m. on the date of the trustee's sale, if the trustee's deed conveying the property to the BFP is recorded:

- within **15 calendar days** after the date of the trustee's sale; or

- the **next business day** following the fifteenth day after the sale if the county recorder in the county where the property is located is closed on the fifteenth day. [CC §2924h(c)]

The title received by the third party BFP bidder at the trustee's sale is clear of any interest claimed by the owner, lienholders or tenants whose interests are junior to the foreclosed trust deed. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

More importantly, the title is taken clear of any **unrecorded prior interests** or **claims** in the property held by persons **not in possession** of the real estate. However, the highest bidder must be a BFP with no *constructive notice* or actual knowledge of those priority claims when acquiring title to the property at the trustee's sale. [CC §§1107, 1214]

Additionally, a *lis pendens* recorded against the real estate prior to the trustee's sale places bidders on constructive notice of a lawsuit involving a claim to a right in title or to possession of the real estate. The claim may have **priority** to the trust deed being foreclosed. If so, the **lis pendens** destroys the BFP status of the highest bidder as to the person asserting the claim, called a *claimant*.

Tax aspects of financing

Chapter 73 — Deductions of points by homebuyers

This chapter discusses the income tax deductions a homebuyer or homeowner may take for the loan points and origination fees incurred on a refinance, purchase-assist or improvement loan.

For a further discussion of this topic, see Chapter 2 of Tax Benefits of Ownership.

Chapter 73 Outline

Prepaid interest write-off exception
The points of interest
Deductible points
Deduction of points on refinancing

Chapter 73 Terms

Accrued interest	*Operating expense*
Deduction	*Personal use loan*
Expense	*Prepaid interest*
Government subsidy	*Refinance*

Prepaid interest write-off exception

Interest on a loan **accrues daily** over the life of the loan. In contrast, a lender's penalty charge (bonus) accrues in its entirety on the occurrence or failure of an event, as with a prepayment penalty or a late charge.

Taxwise, **interest**, no matter the form it may take, which has accrued and been paid on a loan can be written off when determining income tax liability if the interest qualifies as either an *expense* or *deduction* from income.

For example, *accrued interest paid* on a loan, the proceeds of which funded a person's **trade or business activities**, is written off as an *operating expense* of the person's business.

Conversely, **accrued interest paid** on a loan that funded the purchase, improvement or carrying costs of a **rental property** is not an **operating expense** incurred by the property. Thus, mortgage debt on a rental property is not considered when establishing the property's net operating income (NOI). However, interest is written off as a **deduction** from the NOI produced by the rental property (which is also the depreciation allowance). [See Figure 1, **first tuesday** Form 352]

Somewhat different from accounting for interest on a business or rental property, accrued interest paid on a loan that funded the purchase, improvement or carrying costs of **portfolio property** held for long-term profit (such as ground leases, management-free, triple-net leases or land

Figure 1

first tuesday Form 352 - Annual Property Operating Data Sheet (APOD)

ANNUAL PROPERTY OPERATING DATA SHEET

APOD

Prepared by: Agent ______________ Phone ______________
Broker ______________ Email ______________

DATE: ________, 20____, at ______________________, California.

1. PROPERTY TYPE: ______________________
   1.1 Location ______________________
   1.2 APOD figures are estimates reflecting:
      a. ☐ Current operating conditions.
      b. ☐ Forecast of anticipated operations.
      c. Prepared by ______________________

		%
2. INCOME:		
2.1 **Scheduled Rental Income**	$______	100 %
a. Less: Vacancies, discounts and uncollectibles.	– $______	____%
2.2 **Effective Rental Income** [Lines 2.1 less 2.1 a and b]	$0.00	____%
a. Other income	+ $______	____%
2.3 **Gross Operating Income**	$0.00	____%
3. EXPENSES:		
3.1 Electricity	$______	____%
3.2 Gas	$______	____%
3.3 Water	$______	____%
3.4 Rubbish	$______	____%
3.5 Insurance	$______	____%
3.6 Taxes	$______	____%
3.7 Management Fee	$______	____%
3.8 Resident Manager	$______	____%
3.9 Office Expenses/Supplies	$______	____%
3.10 Advertising	$______	____%
3.11 Lawn/Gardening	$______	____%
3.12 Pool/Spa	$______	____%
3.13 Janitorial	$______	____%
3.14 Maintenance	$______	____%
3.15 Repairs and Replacements	$______	____%
3.16 CATV/Phone	$______	____%
3.17 Accounting/Legal Fees	$______	____%
3.18 Credit card charges	$______	____%
3.19 ______________	$______	____%
3.20 ______________	$______	____%
3.21 **Total Operating Expense** [Lines 3.1 to 3.20]	– $0.00	____%
4. NET OPERATING INCOME: [Line 2.3 less 3.21]	$ 0.00	____%

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5. SPENDABLE INCOME (annual projection):
   5.1 **Net Operating Income** (enter from section 4) $0.00 ____%

5.2

Loan	Principal Balance Amount	Monthly Payment	Rate	Due Date
a. 1st	$______	$______	____%	______
b. 2nd	$______	$______	____%	______
c. 3rd	$______	$______	____%	______

   5.3 Total Annual Debt Service [Lines 5.2 a, b and c] – $0.00 ____%
   5.4 **Spendable Income** [Lines 5.1 less 5.3] $0.00 ____%

6. PROPERTY INFORMATION:
   6.1 Price $________; Loan amounts $________; Owner's equity $________.
   6.2 Current vacancy rate or vacant space ____%.
   6.3 Assessor's allocations for depreciation schedule:
   Improvements ____%; Land ____%; Personal property ____%.
   6.4 Property disclosures:
      a. ☐ Rental Income Rent Roll available; [See **ft** Form 352-1] ☐ need confidentiality agreement.
      b. ☐ Rent control restrictions.
      c. ☐ Condition of improvements available: ☐ by owner [See **ft** Form 304-1], ☐ by inspector.
      d. ☐ Environmental report available.
      e. ☐ Natural Hazard Disclosure Statement available. [See **ft** Form 314]
      f. ☐ Soil report available.
      g. ☐ Termite report available.
      h. ☐ Building specification available.
      i. ☐ ______________________
      j. ☐ ______________________

7. REPORTABLE INCOME/LOSS (annual projection): For Buyer to fill out.
   7.1 **Net Operating Income** (NOI) (enter from section 4) $0.00
   7.2 Deductions from NOI
      a. Annual interest expense $______
      b. Annual depreciation deduction $______
      c. Total deductions from NOI – $0.00
   7.3 **Reportable Income/Loss** (annual projection) $0.00

Broker: ______________________
Address: ______________________
____
Phone: ______________________
Cell: ______________________
Fax: ______________________
Email: ______________________

I have reviewed and approve this information.
Date: ________, 20____
Owner's name: ______________________
Signature: ______________________
Signature: ______________________

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held for profit on resale), is written off as a **deduction** against any income and profit from all sources within the portfolio income category.

Then, the income or loss within each of the three different income categories is calculated independent of each other category. As a result, the reportable income or loss within one category is not commingled with income from any other category.

In contrast to loans for business, rental or portfolio purposes, home loans are treated differently. A loan that funds the purchase or improvement of an owner's **principal residence** or **second home** is a *personal use loan*. Accrued interest paid on personal use loans is not tax deductible, with some exceptions. One exception to the non-deductibility rule is interest paid on loans **made in connection with** the principal and second residence beyond providing security for payment of the loan.

Under the **non-deductibility exception**, interest accrued and paid on the first and second home loans is written off as a deduction once the owner's adjusted gross income (AGI) has been set. Thus, the home loan interest becomes part of the schedule A *itemized deductions* from AGI which directly reduce the homeowner's taxable income, not his adjusted gross income. Thus, the amount on which he will pay taxes is reduced.

The government *subsidizes* homeownership through interest deductions on home loans which reduces the taxes the homeowner is required to pay. The amount of tax savings range from 10% and 15% for low-income homeowners, to 35% for high-income homeowners on the amount of interest they pay.

Home ownership through tax incentives

Income tax law is often used as a tool by the federal government for social engineering. The social purpose for allowing immediate deduction of points is to encourage renters to purchase homes.

However, a tenant compares the amount of his rent payment with the amount of his potential house payment when deciding to take on the status of homeowner. Since the house payment for new homeowners is typically greater than rent in California, the encouragement has little effect.

While the deduction of loan origination points is financial aid during the new homeowner's first year of increased living costs, the homeowner's tax relief in the following years is limited only to the interest included in the monthly payments and property taxes paid.

However, the deduction of points in the year of closing is more effective in inducing sustainable long-term home ownership than other tax incentives. The deduction of points is not a direct subsidy designed to bail out builders and REO lenders, such as a tax credit for buying a newly constructed home. Tax credits often encourage financially unprepared buyers to purchase homes, shifting the risk of ownership from overextended lenders and builders to homeowners.

Thus, the wealthier one is, to a point, the greater the subsidy for homeownership. Limitations on wealthier homeowners are imposed by the itemized deductions phase out and the alternative minimum tax (AMT) restrictions on allowable deductions.

Wealthier homeowners who are subject to the AMT and have encumbered their first or second home with an equity loan or refinancing (and have used the net proceeds for purposes other than the improvement of, or in connection with, the first or second home) are not allowed to deduct the interest paid on these loan amounts which are not connected to the purchase or improvement of the first and second home. [Internal Revenue Code §56(e)(1)]

The sole basis for allowing the personal interest deduction for a mortgage on a first and second residence is the **federal policy** of encouraging homeownership. The social policy is propagandized by the use of the slogan "The American Dream" and implemented through tax incentives and implicit guarantees for loans held by federally chartered lenders such as Freddie Mac or Gennie Mae. The reasons behind the federal policy are that homeowners generally require less government assistance in their elder years and make more responsible local citizens.

The points of interest

Points paid to a lender to originate a loan are considered *prepaid interest* since points are interest, and the interest has not yet accrued. Points essentially buy down the loan's *par rate* for the life of the loan to the interest rate denominated in the note. No points means a higher *nominal interest rate* will be stated in the note.

As **prepaid interest**, only the fraction of the points paid which accrues each month over the life of the loan, called the *life-of-loan accrual*, may be deducted against that year's income, with exceptions. When the loan amount is fully prepaid, any remaining unaccrued prepaid interest can then be deducted.

As an exception to the **life-of-loan** accrued reporting, the entire amount of the points paid on loans that assist in the purchase or improvement of an individual's **principal residence** (not a second home) is allowed as a *personal deduction* in the year the loan originated.

The immediate deduction for all points paid in connection with a loan that finances the purchase or improvement of the taxpayer's primary home is another **government subsidy**, part of the overall policy to encourage homeownership in lieu of renting. [IRC §461(g)(2)]

The points deduction exception for a principal residence does not include points paid on loans secured by second homes or vacation residences.

Further, the deductibility of the loan points in the year paid, instead of over the life of the loan, depends on **who paid the points**— the buyer, the seller or the lender.

For example, a homebuyer applies for a loan to fund the purchase of property he will occupy as his principal residence. The loan will be secured by the residence. The lender will be paid points (prepaid interest) for making a purchase-assist loan at an interest rate below the **par rate** for the loan. The lender will not withhold the points from the loan proceeds (as a discount) or add them to the loan balance.

The points will be paid by either the homebuyer from his separate funds, or by the seller, under the terms negotiated by the buyer and his agent in the purchase agreement.

In this situation, the homebuyer can write off the points paid to the lender as a **current deduction** from his adjusted gross income (AGI), since:

- the loan proceeds are used to **purchase or improve** the borrower's principal residence;
- the loan is **secured** by the principal residence, with or without any additional security;
- the Uniform Settlement Statement (USS) accounts for the points paid as "points," "loan origination fees," "loan discount" or "discount points", and compute them as a percentage of the loan;
- the points were paid by the seller or from the buyer's separate funds, not as a discount or add-on by the lender;
- the payment of points is an established business practice of lenders in the area; and
- the points paid do not exceed the amount of points generally charged in the surrounding area. [Revenue Procedure 92-12]

Deductible points

To deduct the points in the year they are paid, the purchase-assist or improvement loan must be **secured by** a buyer's or homeowner's principal residence.

When the loan is secured solely by property other than the residence purchased or improved with the loan funds, such as business or rental property owned by the homeowner or others, the points must be deducted over the life of the loan.

Likewise, points paid by a buyer to finance the purchase or improvement loan for a **second residence** must be deducted as they accrue over the life of the loan. For example, points paid on a purchase-assist loan for a vacation home, payable monthly with a 30-year amortization, will be deductible 1/360th for each month of the tax year as the prepaid interest accrues.

Loan costs incurred by the lender and paid by the owner on any type of real estate to originate a purchase or improvement loan are *capitalized* by the owner. Thus, loan costs are added to, and become part of, the owner's **cost basis** in the property and are not deducted or expensed as interest.

Loan charges are non-recurring costs incurred to acquire or improve property, not daily recurring interest which can be expensed or deducted as it accrues and is paid or was prepaid. [**Lovejoy** v. **Commissioner of Internal Revenue Service** (1930) 18 BTA 1179]

Capitalized costs for originating a loan on property other than the first and second home are partly recovered by annual depreciation deductions, and fully recovered when the property is sold.

Deduction of points on refinancing

Consider a homeowner who refinances the existing purchase-assistor improvement loan on his principal residence and pays the points for the refinancing from his separate funds.

Here, the **refinancing** did not fund the purchase or improvement of the residence, even though it funded the payoff of a purchase or improvement loan. Thus, the points on a refinance are annually written off as they accrue monthly over the life of the loan.

However, if a homeowner uses the **excess loan proceeds** from refinancing to make home improvements, a pro rata share of points paid from the homeowner's separate funds (equal to the percentage of the loan funds which paid for improvements) can be deducted in the year the homeowner refinanced his personal residence. [Revenue Ruling 87-22]

When the homeowner sells his residence or refinances again, the unaccrued points remaining on the existing loan are reported (with itemized deductions) as interest paid in the year of the sale, whether the loan is paid off or assumed by a buyer.

Consider a different homeowner who refinances his principal residence to reduce his monthly payment by $500. The monthly savings are then spent on home improvements, such as a roof replacement and remodeling of the kitchen and bathrooms.

The homeowner deducts all the points he paid for refinancing in the year he refinanced as an itemized deduction on his federal income tax return. He claims the refinancing freed up money for the improvements and was thus a property improvement loan.

The Internal Revenue Service (IRS) disallowed the deduction, claiming the refinancing merely funded the payoff of an existing loan on the property with no net loan proceeds for any improvements.

In this scenario, the deduction of all the points paid to refinance the existing loan is permitted. The refinancing was a loan the homeowner incurred **in connection with the improvement** of the property. The reduction in payments caused the homeowner to have funds to pay for the improvements he then made on the property. [Tax Court Summary Opinion 2005-125 (non-precedent)]

Chapter 74 — Home loan interest deductions

This chapter reviews the home loan interest deduction for reporting the tax consequences of financing first and second homes.

For a further discussion of this topic, see Chapter 1 of Tax Benefits of Ownership*.*

Chapter 74 Outline

Two residences, two deductions
Purchase/improvement loans
Refinancing limitations
$100,000 home equity loans
Property value ceiling
Qualifying the principal residence and second home
Taking the deductions
The home as additional security
The PMI deduction

Chapter 74 Terms

Fair market value	*Personal expense*
Improvement loans	*Principal residence*
Interest accrued and paid	*Purchase loans*
Itemized deduction	*Qualified interest*

Two residences, two deductions

The federal government has a long-standing policy of encouraging **residential tenants** to become homeowners through the use of subsidies built into the **tax codes**. The incentive provided by the government to individual tenants is in the form of a significant reduction in the income taxes they will be required to pay if they **finance the purchase** of a residence or a vacation home.

For a residential tenant considering his income taxes, the monthly payment on a purchase-assist home loan is not just a substitute for his monthly rent payment, it also reduces his combined state and federal taxes by an amount equal to 20% to 30% of the monthly loan payment.

Real estate agents handling the sale or purchase of single family residences must be able to intelligently discuss this tax reduction incentive with residential tenants if the tenants are to be persuaded to buy based on the full range of homeownership benefits.

Due to the special home loan interest deduction rule for income tax reporting, the interest *accrued and paid* on loans is deductible from income as an itemized expense if:

- the loans funded the **purchase price** or paid for the **cost of improvements** for the owner's principal residence or second home; and

- the loans are secured by either the owner's **principal residence** or **second home**. [Internal Revenue Code §163(h)]

Without the home loan interest deduction rule, interest paid on a loan which funded the purchase or improvement of a principal residence or second home is not deductible. If the loan did not fund the purchase or improvement of the principal residence or other *personal expense*, it funded the acquisition of an investment or business property.

Also, interest paid on **equity loans** secured by the property owner's principal residence or second home is tax deductible under the home loan interest deduction rules, whether or not the loan's net proceeds were used for personal or investment/business purposes.

The loan interest deductions for the first and second home reduces the property owner's taxable income as an *itemized deduction* under both the standard income tax (SIT) and the alternative minimum tax (AMT) reporting rules. In contrast, the real estate **property tax deduction** on the first and second homes applies only to reduce the owner's SIT, not his AMT.

Two categories of loans exist to control the deduction of interest paid on any loans secured by the principal residence or second home, which include:

- interest on the balances of *purchase or improvement loans* up to a combined principal amount of $1,000,000; and

- interest on all other loan amounts up to an additional $100,000 in principal, called *home equity* loans.

Purchase/improvement loans

Interest paid on money loans and carryback credit sales originated to **purchase or substantially improve** an owner's first or second home is fully deductible on combined loan balances of up to $1,000,000 for an individual and for couples filing a joint return if the loan is secured by either home. The loan balance is limited to $500,000 for married persons filing separately.

Thus, if the loan funds are used to acquire, construct, or further improve a principal residence or second home, and the loan funds, collectively exceed $1,000,000, only the interest paid on $1,000,000 of the purchase and improvement loan balances is deductible as purchase/improvement interest. However, interest paid on the excess loan amounts, up to an additional $100,000, qualifies for a deduction as interest paid on a home equity loan.

To qualify home improvement loans for interest deductions, the new improvements must be *substantial*. Improvements are **substantial** if they:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property to residential use.

Loan funds spent on repairing and maintaining property to keep it in good condition do not qualify as funding for substantial improvements. [IRC §163; Temporary Revenue Regulations §1.163-8T]

Refinancing limitations

If an owner **refinances** a purchase/improvement loan, the portion of the refinancing used to fund the payoff qualifies as a purchase/improvement loan for future interest deductions. However, interest may only be written off as a purchase/improvement loan on the amount of refinancing funds used to pay off the **principal balance** on the existing purchase/improvement loan.

For example, consider an owner who borrows $200,000 to fund the purchase of his principal residence. The loan balance is paid down to $180,000 and the owner refinances the residence, paying off the original purchase/improvement loan. However, the new loan is for a greater amount than the payoff demanded on the old loan.

In this scenario, interest on only $180,000 of the refinancing is deductible as interest paid on a purchase or improvement loan, unless:

- the excess funds generated by the refinance are used to improve the residence; or
- the excess loan amount qualifies as a home equity loan under its separate ceiling of $100,000 in principal.

$100,000 home equity loans

Interest on loan amounts secured by the first or second home may not qualify for the purchase/improvement home loan interest deduction, due either to a different use of the loan proceeds or the $1,000,000 loan limitation. However, the interest on loan amounts which are secured by the first or second residence and do not qualify as purchase/improvement loans is deductible by individuals and those couples filing joint returns as interest paid on additional or other loan amounts up to $100,000 in principal, called *home equity loans*.

For married persons filing separately, the cap for the principal amount of equity loans on which interest can be deducted is limited to $50,000, half of the joint $100,000 ceiling. [IRC §163(h)(3)(C)(ii)]

Home equity loans are typically junior encumbrances, but also include proceeds from a refinance which do not qualify as purchase/improvement funds and purchase/improvement loan amounts which exceed the $1,000,000 ceiling.

The proceeds from home equity loans may be used for any purpose, including personal uses unrelated to the property.

Property value ceiling

Interest paid on any portion of a loan balance which exceeds the *fair market value* of a residence is not deductible. In practice, the fair market value rule applies almost exclusively to home equity loans, including refinancing proceeds of a greater amount than the balance paid off on the purchase/improvement loan that was refinanced. [IRC §163(h)(3)(C)(i)]

The **fair market value** of each residence is presumed to be the original amount of the purchase price plus any improvement costs. Thus, any **future drop in property value** below the balance remaining on purchase-assist loans does not affect the interest deduction. [Temp. Rev. Regs. §1.163-10T]

Qualifying the principal residence and second home

To qualify for a home loan interest deduction, loans must be secured by the principal residence or second home.

A *principal residence* is defined as an individual's home where the homeowner's immediate family resides a majority of the year, which is close to the homeowner's place of employment and banks which handle the homeowner's accounts, and the address of which is used for tax returns. [IRC §163(h)(4)(A)(i)(I)]

A *second home* is any residence selected by the owner from year to year, including mobile homes, recreational vehicles and boats.

If the second home is **rented out** for portions of the year, the interest qualifies for the home loan interest deduction if the owner occupies the property for more than 14 days or 10% of the number of days the residence is rented, which ever number is greater. [IRC §280A(d)(1)]

If the owner does not rent out his second home at any time during the year, the property qualifies for the home loan interest deduction whether or not the owner occupies it. [IRC §163(h)(4)(A)(iii)]

The rental income on the second home is *investment/portfolio income* if the home qualifies for the interest deduction due to the owner's days in occupancy exceeded the 14-day/10% rule.

If the second home has been rented, but the owner's family occupied the property for more than 14 days or 10% of the days rented thus qualifying the home for the loan interest deduction, the owner is not allowed to treat the property as an investment. Since the property is not an investment, the owner cannot depreciate the home. [IRC §§163(h)(4)(A)(i)(II); 280A(d)(1)]

A second home, when purchased for personal use and held for a profit on resale, also qualifies as investment (like-kind) property for exemption from profit taxes under IRC §1031. [IRC §1221; IRS Private Letter Ruling 8103117]

The tax-exempt sale by §1031 reinvestment

Numerous benefits and advantages are available to sellers of §1031 *like-kind* properties who, rather than "cash out" on the sale of their property, **couple the sale** with the purchase of replacement property(ies). Thus, a reinvestment is arranged that establishes the seller's **continuing investment** in the ownership of like-kind real estate, a requirement to qualify the sale for profit tax exemption under Internal Revenue Code (IRC) §1031.

Section 1031 (**like-kind**) property consists of two classifications of property:

- investment property, called capital assets [IRC §1221]; and
- trade or business property. [IRC §1231]

One or more of these benefits and advantages becomes the **motivating factor** influencing an investor's decision to sell one property and buy replacement property in a tandem transaction, called a *§1031 reinvestment plan*.

If a broker knows the advantages of buying and selling under §1031 rules, the broker can:

- undertake the duty to determine how his client might benefit from §1031 tax treatment by advising his client about the benefits;
- arrange a reinvestment where the motives of opposing parties to buy or sell may differ; and
- be rewarded by receiving two fees for giving advice and assistance in the negotiations of the two transactions.

The benefits and advantages available to real estate investors, one or more of which may influence the investor's decision to enter into a §1031 reinvestment plan, include:

- an **exemption** from reporting all or a portion of the profit on the sale;
- an increase in **debt leverage** and **income yield** by replacing the property being sold with a higher-priced, more efficient and more productive property;
- an increase in the **depreciation deduction** schedules by assuming (or originating) larger amounts of debt on higher-priced replacement property as part of a fresh start for allocation of basis between land and depreciable improvements;
- the **avoidance of costs** incurred to originate new financing by assuming or taking title subject to the existing loans on the properties sold or acquired;
- an **inflation and appreciation hedge** to take maximum advantage of an anticipated rapid increase in cyclical property values by acquiring highly leveraged property to replace a lower-leveraged property; and
- the **relocation** of an equity in property, undiminished by taxes, by an investor who himself moves to a new geographic location.

*Editor's note – For more information on structuring a §1031 reinvestment plan, please see **first tuesday's** The §1031 Reinvestment Plan textbook available in the **Library** section of the **first tuesday** Forms-on-CD and from within your **Student Homepage** at www.firsttuesday.us.*

Taking the deductions

Interest deductions on home loans are only allowed for interest which has **accrued and been paid**, called *qualified interest*. [IRC §163(h)(3)(A)]

Interest on first and second home loans is deducted from an owner's **adjusted gross income** (AGI) as an *itemized deduction*. Further, limitations exists on the total amount of all deductions the homeowner can claim. Conversely, business, rental or investment interest are adjustments that reduce the AGI. Thus, the two types of home loan interest deductions directly reduce the amount of the owner's taxable income (if the interest deductible is not limited by ceilings on the homeowner's itemized deductions).

The inability to reduce the owner's AGI by use of the home loan interest makes a substantial difference for high income earners. The higher an owner's AGI, the lesser the amounts allowed for rental loss deductions, *itemized deduction phaseout*, and any tax credits available to the owner. [IRC §163(a), (h)(2)(A)]

Consider a homeowner who wants to generate funds to use as a down payment to purchase business, rental or investment real estate. His only substantial asset is the $300,000 equity in his home.

If the owner further finances with a home equity loan or refinances the existing loan to net $200,000 in loan proceeds, he will be paying interest which is only partially deductible. The non-purchase/improvement loan amount exceeds the $100,000 home equity loan cap. The interest the owner pays on the portion of home equity loan balance in excess of the $100,000 loan cap is not deductible under the home loan interest deduction rules.

The home as additional security

Consider a homeowner who encumbers the equity in his home to secure a note he executes as the down payment on the purchase of investment property.

The homeowner wants to avoid the home loan interest deduction limitations and be able to write off all the interest paid on the note against future income from the rental or portfolio property he purchased with the loan funds.

Accordingly, the homeowner negotiates with the lender or carryback seller for the note to be secured by **two separate trust deeds**; one as a lien on the home and the other as a lien on the property purchased.

The lender or carryback seller is satisfied with the financial risk regarding the loss of principal. The lender or carryback seller receives a trust deed on the home, which he views as his primary source of recovery if the owner defaults on the note.

In addition to the owner's home, the note is secured by the property purchased, to justify writing off the entire interest accrued and paid on the loan against income from the property purchased. The home is merely used as **additional security** under a separate trust deed.

Property Management

Chapter 75 Property management licensing

This chapter reviews the licensing requirements for property managers and resident managers, and their employees.

For a further discussion of this topic, see Chapter 7 of Real Estate Property Management.

Chapter 75 Outline

When is a DRE license required?
Unlicensed employee activity
Power-of-attorney exemption
Apartment resident manager exemption
Other licensing exceptions
Contingent fees and bonus awards

Chapter 75 Terms

Department of Real Estate	*Unlawful detainer*
Licensed employee activities	*Unlicensed employee activities*
Tenant negotiations	

When is a DRE license required?

An individual owns and operates income-producing real estate. As the owner-operator, he locates and qualifies tenants, prepares and signs occupancy agreements, delivers possession, contracts for property maintenance, collects rent, pays expenses and mortgages, serves any notices and initiates any unlawful detainer (UD) actions to evict tenants.

Does the **owner-operator** need a real estate broker's license to perform these activities?

No! The owner of income-producing real estate does not need a real estate broker license to operate **as a principal**. The owner-operator is not acting **on behalf of someone else** as an agent when he is managing his own property. [Calif. Business and Professions Code §10131(b)]

On the other hand, if the owner-operator decides to hire an individual to take over the general management of the apartment complex, the individual he employs to act as his property manager must be licensed as a California real estate broker.

A real estate broker license must be held by an individual or corporation that, with expectation of a fee, offers to or performs any of the following services **for another individual**:

- list real estate for rent or lease;

- market the property to locate prospective tenants;
- list prospective tenants for the rental or lease of real estate;
- locate property to rent or lease;
- sell, buy or exchange existing leasehold interests in real estate;
- manage income-producing properties; or
- collect rents from tenants of real estate. [Bus & P C §10131(b)]

An individual employed by the broker to act as his agent to perform any of the **services requiring a license** must also be licensed by the Department of Real Estate (DRE), either as a broker or sales agent, with the exception of agents employed by a broker to handle multiple **residential units**. [Bus & P C §10131.01(a)(3)]

For licensing purposes, the activities of an individual employed by a real estate broker to act as his agent in the rental and leasing of **residential complexes**, other than single family units, are categorized as either:

- **licensed employee activities**, such as **landlord-related** solicitations, listings and rental or lease negotiations, care and maintenance of the property, marketing of the listed space and accounting; or
- **unlicensed employee activities**, such as **tenant-related** negotiations, such as showing properties, giving out leasing information and screening applications, and accepting rental or lease agreements, deposits and rent.

For **licensed employee activities** performed by an agent of the broker who solicits or has entered into a property management agreement or a leasing agent agreement, the agent must also be licensed as a broker or sales agent. Activities requiring licensing relate to contacts with the owner, not the tenant, about the leasing, care of the property and accounting.

Unlicensed employee activity

While under the supervision and control of a licensed broker, administrative and **non-discretionary duties** carried out by employees on behalf of the broker who is managing transient housing or apartment complexes are *exempt* from real estate licensing requirements. [Bus & P C §10131.01(a)]

Tenant negotiations that can be performed by unlicensed agents on behalf of a broker who has been retained to manage an apartment building, complex or court include:

- showing rental units and facilities to prospective tenants;
- providing prospective tenants with information about rental rates and rental and lease agreement provisions;

- providing prospective tenants with rental application forms and answering questions regarding their completion;
- accepting tenant screening fees;
- accepting signed lease and rental agreements from tenants; and
- accepting rents and security deposits. [Bus & P C §10131.01(a)(1)]

Power-of-attorney exemption

Also exempt from licensing is an individual who has been given authority to act as an "attorney in fact" under a power of attorney to **temporarily manage** an owner's property. [Bus & P C §10133(a)(2)]

However, a power of attorney cannot be used as authority to continuously manage real estate and cannot substitute for a broker's license.

Apartment resident manager exemption

Apartment building management has special licensing rules distinguishing resident managers from nonresident property managers.

A resident manager is employed by either the landlord or the broker who is the property manager of the apartment building or complex. The resident manager lives on the premises as a requirement of his employment.

A resident manager and his employees do not need a real estate license to manage the apartment complex. [Bus & P C §10131.01(a)(1)]

However, a resident manager of one apartment complex is barred from being the property manager of a separate apartment complex unless he is licensed, even if both properties are owned by the same landlord. The resident manager would be a nonresident property manager of the other complex. Thus, he would need to be licensed. [Bus & P C §10131(b)]

Editor's note — Apartment complexes with 16 or more units must have a resident manager. [25 Calif. Code of Regulations §42]

Other licensing exceptions

A person is not required to have a real estate broker's license when he is acting:

- as an attorney performing management as part of his legal services [Bus & P C §10133(a)(3)]; or
- under court appointment, such as a receiver or bankruptcy trustee. [Bus & P C §10133(a)(4)]

These exceptions are usually short-term and refer to specific properties. A person whose business is advertised or held out as including property management for others must comply with the licensing laws. Individuals managing property without a license and without qualifying for

an exemption will not be able to enforce collection of the fee they were to receive. [Bus & P C §10137]

Contingent fees and bonus awards

If a landlord is a corporation, limited liability company (LLC) or partnership, any officer of the entity may manage the entity's property without a broker's license. However, the unlicensed officer may not receive any contingent fees or extra compensation based on achievement, production or occupancy factors during his management of the property. He must be salaried or on wages. [Bus & P C §10133(a)(1)]

Similarly, where a LLC owns the property, the manager of the LLC need not be licensed to manage the property — provided fees are not paid based on the quantity of leases negotiated or the LLC's rental income. [Bus & P C §10133(a)(1)]

If the LLC manager receives a percentage of gross rents as compensation, the compensation is considered a **contingent fee** unless all the members of the LLC receive the same percentage.

A property manager paid on a contingent fee basis, or any other employee or officer whose pay is structured as a contingency fee, of an office building, shopping center, industrial park, apartment building or other income property will need a broker's license if his duties include recruiting tenants, negotiating leases or collecting rents. However, employees of a broker dealing exclusively with prospective tenants for units in apartment complexes are not required to possess a license. [Bus & P C §10131(b)]

Bonus, award, fee, incentive or contingency fee programs in excess of a base salary require the person receiving them to be licensed by the DRE, whether they are resident managers, assistant resident managers or maintenance personnel. Examples of these programs include:

- a flat dollar fee for each new tenant;
- a monthly flat dollar fee for each new tenant;
- a percentage fee based on increases in rents; and
- a percentage of monthly gross rents if rents collected for the month exceed a percentage of scheduled income.

Chapter 76 — Exclusive authorization to lease

This chapter highlights the conditions which allow a broker to collect a fee from a nonresidential landlord when employed as an exclusive leasing agent.

For a further discussion of this topic, see Chapter 12 of Real Estate Property Management.

Chapter 76 Outline

Leasing agent's bargain for fees
Right to compensation for services
Exclusive authorization to locate a user
Ready, willing and able tenant condition
An exclusive right-to-collect clause
Early termination by landlord triggers fee
Safety clause covers prospects who lease
Contingency fees due on landlord's breach
Additional fees on extension of lease

Chapter 76 Terms

Compensation	*Right-to-collect clause*
Early-termination option	*Safety clause*
Listing	*Termination-of-agency clause*
Open listing	*Users*

Leasing agent's bargain for fees

A nonresidential property is offered for lease by an owner, also called the landlord. A broker makes an appointment with the owner to discuss the possibility of becoming his leasing agent.

During the discussion, the broker explains he can best help lease the property if he is operating under a signed exclusive authorization to lease, also called a *listing*. Under the listing, the broker, on the owner's behalf, will be able to:

- market the space and locate prospective tenants, called *users*, his due diligence effort as the owner's sole representative [See Figure 1, **first tuesday** Form 110 §1];
- publish the terms under which a user can actually lease and occupy the space [See Figure 1, **first tuesday** Form 110 §8];
- assure other brokers the owner has agreed to pay a fee that can be shared with brokers who represent users [See Figure 1, **first tuesday** Form 110 §4.2]; and

- conduct negotiations with users or their brokers, and accept deposits with offers to lease the space. [See Figure 1, **first tuesday** Form 110 §4.3]

The broker will not be managing the property, only locating prospective tenants and leasing space.

Right to compensation for services

The exclusive authorization listing assures the broker he will receive a fee for his efforts if anyone procures a tenant during the listing period, either on:

- the leasing terms sought in the listing; or
- other terms accepted by the owner.

However, the owner is reluctant to give up his ability to lease the property himself. Further, he would like to avoid employing the broker and paying a brokerage fee.

On the other hand, the owner does have a better chance of finding a tenant on acceptable terms in the rental market if he is represented by a member of the local brokerage community of leasing agents. An effective leasing agent takes the owners “rough edges” out of negotiations and is constantly involved in leasing discussions with others.

Ultimately, the owner prefers to orally agree to employ the broker. He confirms he will work exclusively with the broker to market the space and locate a user. The owner does not, however, believe it is necessary to have a written agreement — a handshake and his word should do the job.

The broker explains an exclusive authorization must be written and signed by the owner for the broker to be entitled to collect a fee — no signed writing, no services.

Is the broker correct in his analysis?

Yes! A written agreement signed by the client is the only way a broker can protect his right to compensation for services and impose a due diligent obligation on himself to conscientiously and continuously work to meet the client’s objectives, whether representing a tenant or a landlord.

An oral fee agreement between a broker and his client, be he a tenant or an owner, **without a later writing** signed by the client, is unenforceable by the broker.

Oral fee agreements to lease space are unenforceable even when the broker documents the oral agreement by referencing the fee and terms of payment in written correspondence sent to and acted on by the client. The client must sign the promise to pay. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

Thus, a broker best protects his right to collect a fee for acting on behalf of an owner by entering into an exclusive authorization, signed by the owner, before performing any services.

Figure 1 ***first tuesday*** *Form 110 -*
Exclusive Authorization to Lease Property

EXCLUSIVE AUTHORIZATION TO LEASE PROPERTY

Prepared by: Agent ____________ **Phone** ____________
Broker ____________ **Email** ____________

DATE: ________, 20 ____, at ____________________, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Landlord hereby retains and grants to Broker the exclusive and irrevocable right to solicit prospective tenants and negotiate for the lease of the property for the period beginning on ________, 20 ____ and terminating on ________, 20 ____.

1.2 Broker to use diligence in the performance of this agreement.

2. ADDENDUMS to this agreement include:

a. ☐ Title Report, or ☐ Title Policy
b. ☐ Work Authorization [See **ft** Form 108]
c. ☐ Occupant's Operating Expense Profile [See **ft** Form 562]
d. ☐ Criminal Activity and Security Disclosure Statement [See **ft** Form 321]
e. ☐ Agency Law Disclosure [See **ft** Form 305]
(Mandated for one-to-four residential units if lease exceeds one year.)
f. ☐ Lead-Based Paint Disclosure [See **ft** Form 557]
(Mandated for one-to-four residential units constructed before 1978.)
g. ☐ ____________
h. ☐ ____________

3. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between the Client and Broker.

3.1 Landlord agrees to pay Broker ☐ see attached fee schedule [See **ft** Form 113], or ____________ as compensation for services rendered, IF:

a. Anyone procures a tenant on the terms stated in this agreement, or any other terms acceptable to Landlord, during the period of this agreement.
b. The property is withdrawn from the rental market or made unmarketable by Landlord during the period of this agreement.
c. The Landlord terminates this employment of the Broker during the period of this agreement.
d. Within one year after termination of this agreement, Landlord or his agent commences negotiations which later result in a transaction contemplated by this agreement with a tenant with whom Broker, or a cooperating broker, negotiated during the period of this agreement. Broker to identify prospective tenants by written notice to the Landlord within 21 days after termination of this agreement. [See **ft** Form 122]

3.2 Should this agreement terminate without Landlord becoming obligated to pay Broker a fee, Landlord to pay Broker the sum of $________ per hour of time accounted for by Broker, not to exceed $________.

3.3 If Broker procures a tenant who purchases the property during the term of Tenant's lease or any modification, extension or renewal of the lease or other continuing occupancy of leased property, Landlord agrees to pay Broker a fee of ☐ see attached fee schedule [See **ft** Form 113], or ____________.

4. GENERAL PROVISIONS:

4.1 Broker is authorized to place a For Lease sign on the property and publish and disseminate property information to meet the objectives of this employment.

4.2 Landlord authorizes Broker to cooperate with other agents and divide with them any compensation due.

4.3 Broker is authorized to receive, on behalf of any tenant, an offer and deposit.

4.4 The Landlord's acceptance of any tenant's offer to lease to be contingent on approval of the tenant's creditworthiness and management capabilities.

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— — — — PAGE TWO OF THREE — FORM 110 — — — —

4.5 Broker may have or will contract to represent Owners of comparable properties or represent Tenants seeking comparable properties during the retainer period. Thus, a conflict of interest exists to the extent Broker's time is required to fulfill the fiduciary duty owed to others he now does or will represent.

4.6 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

4.7 The prevailing party in any action on a dispute shall be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

4.8 This agreement will be governed by California law.

5. REAL ESTATE:

5.1 Type ____________
Address ____________
Referred to as ____________
____
____
____
Vesting ____________

5.2. Encumbrances of record:

a. A first loan in the amount of $________, payable $________ per month until paid, including interest at ____%, ☐ ARM, type ________, impounds being $________ monthly.
Lender ____________
b. A second loan in the amount of $________, payable $________ per month, including interest at ____%, due ________, 20____.
Lender ____________
c. Other encumbrance, bond, assessment or lien in the amount of $________
d. Any defaults ____________

6. PERSONAL PROPERTY INCLUDED:

6.1 Referred to as ____________
____
____________.

7. CONDITION OF TITLE:

7.1 Landlord's interest in the property is:
☐ Fee simple
☐ Leasehold
☐ ____________

7.2 Landlord warrants there are no unsatisfied judgments or actions pending against him, no condemnation/eminent domain proceedings or other actions against the property, and no unrecorded deeds or encumbrances against the property.

8. LEASE TERMS:

8.1 The lease term sought is for a period of ____________.

8.2 Occupancy to be available ________, 20____.

8.3 Initial rent shall be $________, payable on the ____ day of each month, with annual adjustments based on ____________.

8.4 A total deposit of $________, being $________ advance rents and $________ security deposit.

— — — — PAGE TWO OF THREE — FORM 110 — — — —

— — — — PAGE THREE OF THREE — FORM 110 — — — —

8.5 A late charge of $________ to be incurred ____ days after the rent is due, plus interest at ____% per annum beginning from the due date for the delinquent rent.

8.6 Tenant to pay for and maintain:
☐ Water
☐ Gas
☐ Electricity
☐ Heat/Air Conditioning
☐ Public liability insurance
☐ Property damage insurance
☐ Plate glass insurance
☐ ____________

8.7 Landlord to maintain ____________
____________.

8.8 Tenant may not assign, lease or sublet any portion of the property without written consent of the Landlord.

8.9 The lease form sought to be used by Landlord is form #____ published or drafted by ________.

8.10 Other terms ____________
____

I agree to render services on the terms stated above.
Date: ________, 20____
Broker's Name: ____________
Broker's DRE Identification #: ____________
Agent's Name: ____________
Agent's DRE Identification #: ____________
Signature: ____________
Address: ____________
____
Phone: ____________
Cell: ____________
Fax: ____________
Email: ____________

I agree to employ Broker on the terms stated above.
☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: ________, 20____
Landlord: ____________
Signature: ____________
Address: ____________
____
Phone: ____________
Cell: ____________
Fax: ____________
Email: ____________

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*Editor's note — If a broker is employed to renegotiate an existing lease, his employment agreement does not need to be in the form of a signed written agreement. Fees promised a broker for his negotiation of modifications, space expansions, extensions or renewals of existing leases are not required to be written to be enforceable since the lease has already been created, taking the further employment out from under the statutes (of Frauds) requiring a writing. [**Shell v. Darnell** (1984) 162 CA3d 957]*

Exclusive authorization to locate a user

An exclusive authorization to lease operates like an exclusive right-to-sell listing agreement.

The leasing agent is employed to "sell the use," a leasehold interest, by **locating a user** for the owner's property, rather than "sell the ownership" by locating a buyer for the property.

The broker owes the same obligations and duties to the owner under an exclusive leasing authorization as he would owe to a seller under an exclusive right-to-sell listing. The primary obligation owed an owner seeking tenants is the broker's duty to use diligence in his effort to continuously and conscientiously market the property and locate qualified tenants.

Conversely, a broker's performance under a written open listing requires only his **best efforts**, not constant diligence in the search for a tenant as is required under an exclusive listing.

An **open listing** sets the leasing agent in competition with the owner and other brokers to be the **first to locate** a tenant and become entitled to collect a fee. Hence, the use of the term "vest pocket listing" for open listings, written or oral.

An exclusive authorization to lease calls for a fee schedule to be prepared and attached. The fee schedule references leasing situations which trigger the earning of formulated fees, such as 5% of the total rents for the first five years and 3% of the total rents for the balance of the lease. The schedule includes fees for extensions, renewals and other continuing leasehold and purchase arrangements which might be entered into in the future by the tenant and the owner.

The fee amount established in the fee schedule is earned and due on the occurrence of any one of the following events:

- an exclusive *right-to-collect clause* assures payment of the agreed-to fee if the broker, another broker, the owner or anyone else procures a tenant on the terms stated in the listing or on any other terms accepted by the owner [See Figure 1, **first tuesday** Form 110 §3.1a];
- an *early-termination option* assures payment of the fee should the owner withdraw the property from the rental market during the listing period [See Figure 1, **first tuesday** Form 110 §3.1b];
- a *termination-of-agency clause* assures payment of the fee if the owner cancels the employment without cause before it expires under the listing [See Figure 1, **first tuesday** 110 §3.1c]; and

- a *safety clause* assures payment of the fee if, within a year after termination of the exclusive authorization, the owner enters into negotiations resulting in the leasing or selling of the property to a prospective tenant the broker negotiated with during the listing period. [See Figure 1, **first tuesday** Form 110 §3.1d]

Ready, willing and able tenant condition

Now consider a broker who is employed by a landlord under an exclusive authorization to lease.

The authorization states the landlord will pay the broker a fee if the broker, or anyone else including the landlord, produces a tenant ready, willing and able to lease the property on the same terms specified in the exclusive authorization agreement. [See Figure 1, **first tuesday** Form 110 §3.1a]

The broker produces a creditworthy tenant who is financially capable of leasing the premises on the terms set forth in the exclusive authorization agreement. [See Figure 1, **first tuesday** Form 110 §8]

The broker prepares and submits the tenant's **offer to lease** on terms substantially identical to the leasing terms in the authorization, called a full listing offer. [See Form 556 accompanying this chapter]

The landlord refuses to accept the offer, disclosing to the broker he now wants a higher rental rate.

The broker claims he is entitled to his fee since he produced a tenant who is ready, willing and able to lease the property on the terms stated in the exclusive authorization agreement.

The landlord claims the broker is not entitled to a fee since the property was never leased.

Here, a written fee agreement exists under which the broker only needs to **locate a tenant** ready, willing and able to lease the landlord's property **on the terms listed** for the broker to earn and be entitled to immediate payment of his fee. [**Twogood** v. **Monnette** (1923) 191 C 103]

An exclusive right-to-collect clause

Now consider a broker whose exclusive authorization to lease contains a fee provision that states he is entitled to a fee if the landlord rents the space during the listing period, called a *right-to-collect clause*. It is the **right-to-collect clause** which makes an exclusive listing exclusive. The clause states "a fee is due if anyone procures a tenant." [See Figure 1, **first tuesday** Form 110 §3.1a]

The broker, as part of his efforts to locate a tenant, places a "For Lease" sign on the premises. The sign is seen by a prospective tenant.

Without contacting the broker, the prospective tenant contacts the landlord of the premises.

OFFER TO LEASE

Prepared by: Agent ____________________________ **Phone** ______________________
Broker ____________________________ **Email** ______________________

DATE: _______________, 20______, at ____, California.
Items left blank or unchecked are not applicable.
Received from ____, the sum of $_______________,
evidenced by ☐ check, or __________________________ ☐, payable to ___________________________________,
to be held undeposited until acceptance of this offer as a deposit toward the leasing of the premises referred to as
____.

The following checked addendums are part of this offer to lease:
☐ Plat of the premises
☐ Lease agreement
☐ Standard Option to Purchase [See **ft** Form 161]
☐ Credit Application [See **ft** Form 302]
☐ Tenant's financial statements
☐ Option to Renew/Extend [See **ft** Form 565]
☐ Right of First Refusal to Buy [See **ft** Form 579]
☐ _____________________________

TERMS:

1. The commencement date of the lease to be ____________, 20______, and continue ☐ until the expiration date of _____________, 20______, or ☐ as a month-to-month tenancy.

2. The monthly rent to be payable in advance as follows:
2.1 ☐ Monthly rent to be fixed at $_______________ until expiration of the lease.
2.2 ☐ Monthly rent to be adjusted from a monthly base rent for the first year of $_______________.
On each anniversary date of the lease, the monthly base rent shall be adjusted upward only based on the annual increase in the Consumer Price Index for All Urban Consumers (CPI-U) for:
☐ Los Angeles-Anaheim-Riverside ☐ San Diego ☐ ______________________
☐ San Francisco-San Jose-Oakland ☐ National
a. The upward adjustment for any one year is capped at a ______% annual increase.
2.3 ☐ Monthly rent to be graduated on each anniversary under the following schedule:
a. Base year monthly rent of $_______________, and on each anniversary month, an upward adjustment in the monthly rent of ______% over the prior year's monthly rent; or ________________________________
____.
b. Base Year $______________ Second Year $______________ Third Year $_______________
Fourth Year $______________ Fifth Year $______________ Sixth Year $_______________
2.4 ☐ Rent to be the greater of ______% of monthly gross sales/receipts or the total of other rents, taxes, insurance and common area maintenance (CAMs) checked in this offer.
2.5 ☐ Monthly base rent to be adjusted upward to current market rental value every ______ years.
2.6 Holdover rent to be $_______________ daily.

3. The utility expenses for the space leased to be paid as follows:
Tenant to pay ____
Landlord to pay ____

4. ☐ Common Area Maintenance (CAMs) costs for maintaining and operating of the common areas are to be paid by Tenant based on his proportionate share of the total space leased on the premises, or _____%. The CAMs charge shall be assessed ☐ monthly, or ☐ quarterly, and is payable within 10 days. The CAM charge will not exceed ☐ ______% of the rent, ☐ ______ cents per square foot monthly, or ______________________.

5. Real estate taxes and assessments on the real estate shall be paid by ☐ Landlord, or ☐ Tenant.
5.1 Any taxes and assessments paid by Tenant to be capped at a ______% annual increase.

6. A security deposit of $_______________ to secure the performance under Tenant's lease to be paid on signing of the lease.

7. ☐ Tenant to have the option to renew or extend the lease as set forth in the attached option to renew/extend. [See **ft** Form 565]

8. Tenant may assign, sublet or encumber the leasehold interest subject to Landlord's consent.

9. Tenant's intended use of the premises includes ____
____.

10. Landlord to make improvements prior to the time Tenant is to take possession as follows ____________
____
____.

11. Tenant to make improvements as follows ____
____
____.

12. Tenant may exercise the right to lease additional space from Landlord as follows (note the premises, rent, terms, and period) ____
____.

13. Tenant to maintain insurance on the premises to cover any casualty loss in the amount of $______________.

14. Landlord and Tenant to sign a lease to be prepared by ☐ Tenant, or ☐ Landlord, on a form entitled ______________________ published by ______________________.

15. Parties to pay Broker(s) a fee of ☐ see attached fee schedule [See **ft** Form 113], or ______________________
______________________________________, as follows: Landlord to pay the brokerage fee on transfer of possession. The party wrongfully preventing a transfer of possession to pay the brokerage fee. Landlord's Broker and Tenant's Broker, respectively, to share the brokerage fee ____________:____________.

16. This offer shall be deemed revoked unless accepted in writing and personally delivered to Tenant or Tenant's Broker on or before ____________, 20______.

17. Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18. ____
____
____

Landlord's Broker: ______________________
Broker's DRE Identification #: ______________________
Agent's Name: ______________________
Agent's DRE Identification #: ______________________

Signature: ______________________
Is the agent of: ☐ Landlord exclusively.
☐ Both Landlord and Tenant.
Address: ______________________
____
Phone: ______________ Cell: ______________
Fax: ______________________
Email: ______________________

Tenant's Broker: ______________________
Broker's DRE Identification #: ______________________
Agent's Name: ______________________
Agent's DRE Identification #: ______________________

Signature: ______________________
Is the agent of: ☐ Tenant exclusively.
☐ Both Landlord and Tenant.
Address: ______________________
____
Phone: ______________ Cell: ______________
Fax: ______________________
Email: ______________________

I agree to the terms stated above.
☐ See Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20______
Landlord: ______________________
Agent: ______________________
Agent's DRE #: ______________________

Signature: ______________________

I agree to the terms stated above.
☐ See Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20______
Tenant: ______________________

Signature: ______________________
Tenant: ______________________

Signature: ______________________

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Before the exclusive authorization period expires, the prospective tenant and landlord enter into a lease agreement, though the terms are different from those specified in the broker's exclusive authorization.

Even though the landlord's broker had no contact with the prospective tenant (other than the sign exposure), the broker has earned his fee. A tenant's offer to lease was accepted by the landlord during the exclusive authorization period.

Further, the broker receives his fee even though the final terms agreed to by the landlord and the tenant differed from the terms of the listing since the tenant's terms were accepted by the landlord during the exclusive authorization period. [**Carlsen** v. **Zane** (1968) 261 CA2d 399]

Early termination by landlord triggers fee

A typical exclusive authorization agreement contains boilerplate wording in the fee provision stating the landlord will pay the broker the agreed-to fee if the property is:

- withdrawn from the rental market;
- transferred or conveyed;
- leased without the broker's consent; or
- made unrentable by the landlord, called an *early-termination clause*. [See Figure 1, **first tuesday** Form 110 §3.1b]

An **early termination clause** protects the broker from loss of his time and money spent in a diligent effort to locate a tenant should the landlord's conduct effectively remove the property from the rental market before the listing expires. When the landlord interferes with the objective of the employment of the broker — to produce a ready, willing and able tenant on the terms stated — a fee has been earned and is immediately due.

Safety clause covers prospects who lease

A landlord's broker needs to protect his **time and effort** (and monies) spent locating a tenant during the listing period when the effort produces results after the listing expires. The inclusion of a *safety clause* in the fee provisions of an exclusive authorization to lease assures this result. [See Figure 1, **first tuesday** Form 110 §3.1d]

The **safety clause** commits the landlord to pay the broker the scheduled fee if, within **one year after** the exclusive authorization expires, the landlord enters into negotiations during the safety clause period (one year) which later result in a lease of the premises to a tenant who was located and exposed to the property by the broker or his agents during the listing period.

As a "safety net" for brokerage services rendered, the clause discourages the landlord from attempting to avoid payment of the broker's fee by:

- waiting until the exclusive authorization agreement expires and then directly or indirectly approaching a prospective tenant located and solicited by the broker; or

- making special fee arrangements with another broker which re-ignite negotiations with a prospective tenant located and exposed to the property by the prior broker.

Contingency fees due on landlord's breach

Offer-to-lease forms typically contain a provision stating the broker's fee is payable on the transfer of possession to the tenant, called a *contingency fee clause*. [See Form 556 §15]

Sometimes, the lease agreed to in the offer to lease is never entered into by the landlord and prospective tenant. Without a lease, the agreed-to change of possession triggering payment of the fee earned by the broker does not occur due to a breach of the offer to lease by the landlord. As a result, the earned brokerage fee is not paid. The condition for payment of the fee — occupancy — did not occur.

However, a broker may recover contingency fees contained in offers to lease even when, due to a breach by either the landlord or the tenant, the lease agreed to in the offer is not later entered into and possession is not transferred.

Additional fees on extension of lease

Exclusive authorization agreements have fee schedules attached which contain formulas for calculating the brokerage fee earned based on the length of the lease negotiated with the tenant. Further, they usually state the broker will receive an **additional fee** for any extension, renewal or modification of the tenant's occupancy under the original lease.

Chapter 77 — Residential rental and lease agreements

This chapter distinguishes the features of residential lease agreements from month-to-month rental agreements.

For a further discussion of this topic, see Chapter 50 of Real Estate Property Management.

Chapter 77 Outline

Periodic or fixed-term tenancy
Rental market influences
Lease negotiations on expiration
Requisites to accepting tenants
Condition of premises addendum
Pet addendum
Waterbed addendum
Brokerage fee addendum
Other addenda
Terms of residential occupancy
Statutory rights and duties
Brokerage fee addendum
Other addenda
Terms of residential occupancy

Chapter 77 Terms

Expiration	*Periodic tenancy*
Condition of furnishings	*Rental agreement*
Condition of premises	*Security deposit*
Grace period	*Term*
Late charge	*Walk-through*
Lease agreement	*Waterbed addendum*
Leasehold estate	

Periodic or fixed-term tenancy

Residential landlords and tenants enter into either a lease agreement or a periodic rental agreement when the landlord transfers the right to occupy property to the tenant, called *leasing* or *renting* property. Periodic rental agreements are nearly always structured as month-to-month rental agreements.

Other than the **expiration** of the tenancy conveyed by each agreement and the duration of originally agreed rights and obligations, residential lease agreements and rental agreements grant

and impose on the landlords and tenants the same rights and obligations. It is the expectation of continued occupancy and the obligation to pay rent which differs.

Provisions agreed to which are not included as boilerplate provisions in the pre-printed forms used by landlords are included in an addendum to the rental or lease agreement. The provisions are entered on the addendum, and the addendum is referenced in the body of the rental or lease agreement to which it is attached.

Additional terms and conditions placed in addenda include authorization for the tenant to maintain items on the premises such as a pet, fish tank or liquid-filled furniture, or the landlord's grant to the tenant of an option to buy the property or to renew or extend the term of the lease.

A month-to-month **rental agreement** runs for an indefinite period of time since it automatically renews monthly, and on the same terms, until modified or terminated by notice. [See **first tuesday** Form 551 §2]

Month-to-month tenancies, a variety of *periodic tenancies* created by entering into a **rental agreement**, can be terminated by either the landlord or the tenant on 30 days written notice. [Calif. Civil Code §1946; see Chapter 84]

On the other hand, a **lease agreement** creates a tenancy that continues for a fixed period, called its *term*, such as six months or one year, at the end of which the tenant's right to occupy expires. [See Figure 1, Form 550 §2]

Also, the lease terminates at the end of its fixed term without further notice by either the landlord or the tenant, called *expiration* of the lease. Unlike a periodic tenancy, no renewal of a lease occurs on expiration of its term, unless agreed to in an option to renew or extend.

Unlike the required use of a 30-day notice to vacate to bring a month-to-month tenancy to termination, the lease agreement contains the only notice the tenant or the landlord is entitled to receive that the lease terminates. The expiration provision in the lease agreement sets forth the day the right to occupy expires, automatically reverting the right of occupancy to the landlord.

Rental market influences

The population of tenants and the number of properties competing for these tenants, as well as the comparison of a property's location and its amenities to competing properties, create the **rental market**. It is the rental market which sets the amount of rent a residential landlord is able to charge on any given day.

Generally, tenants on month-to-month rental agreements pay higher amounts of rent for a unit than do tenants with lease agreements. Month-to-month tenants pay a premium for the privilege of being able to vacate the premises on 30 days' notice, without liability exposure for future rents. This privilege held by the tenant contributes to the landlord's uncertainty about his income and costs of tenant turnover, hence the premium rent.

Tenants typically pay lower rents when they enter into a lease. In stable rental markets, the longer the lease, the lower the rent.

Figure 1

first tuesday *Form 550 -*
Residential Lease Agreement

RESIDENTIAL LEASE AGREEMENT

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

DATE:____________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This lease agreement is entered into by ______________________________________, as the Landlord, and ____, as the Tenant(s),

1.1 regarding residential real estate referred to as ____
____.

1.2 including the following:
☐ Garage/parking space #______
☐ Storage space #______
☐ Furnishings______________________________________

1.3 The following checked attachments are part of this agreement:
☐ Condition of Premises Addendum [See **ft** Form 560]
☐ Credit Application [See **ft** Form 302]
☐ Condition/Inventory of Furnishings Addendum [See **ft** Form 561]
☐ Rent control disclosures
☐ Brokerage Fee Addendum [See **ft** Form 273]
☐ House/Building rules
☐ Option to Renew/Extend Lease [See **ft** Form 565]
☐ Agency Law Disclosure [See **ft** Form 305]
☐ ______________________________________

AGREEMENT:

2. DEPOSIT:

2.1 Landlord acknowledges receipt of $______________ as a security deposit.

2.2 The deposit is security for the diligent performance of Tenant's obligations, including payment of rent, repair of damages, reasonable repair and cleaning of premises on termination, and any loss, damages or excess wear and tear on furnishings provided to Tenant.

2.3 No interest will be paid on the deposit and Landlord may place the deposit with his own funds, except where controlled by law.

2.4 Within 21 days after Tenant vacates, Landlord to furnish Tenant with a security deposit statement itemizing any deductions, with a refund of the remaining amount.

3. TERM OF LEASE:

3.1 This lease will begin on ____________, 20______, and continue until ____________, 20______.

3.2 The lease terminates on the last day of the term without further notice.

3.3 If Tenant holds over, Tenant to be liable for rent at the daily rate of $______________.

4. RENT:

4.1 Tenant to pay, in advance, $______________ rent monthly, on the ____________ day of each month.

4.2 Rent to be paid by:

a. ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord or his agent and delivered to ____
(Name)
____
(Address)
____
____
(Phone)

Personal delivery of rent to be accepted at Landlord's address during the hours of ______ to ______ of the following days: ____.

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b. ☐ credit card #______/______/______/______ issued by ______________________________, which Landlord is authorized to charge each month for rent due.

c. ☐ deposit into account number ______________________________
at ____
(Financial Institution)
____
(Address)
____

d. ____.

4.3 Tenant to pay a charge of $______________ as an additional amount of rent, due on demand, in the event rent is not received within five days after the due date.

4.4 If any rent or other amount due Landlord is not received within five days after its due date, interest will thereafter accrue on the amount at 18% per annum until paid. On receipt of any past due amount, Landlord to promptly make a written demand for payment of the accrued interest which will be payable within 30 days of the demand.

4.5 Tenant to pay a change of $______________ as an additional amount of rent, due on demand, for each rent check returned for insufficient funds, and thereafter pay rent by cash or cashier's check.

5. POSSESSION:

5.1 Tenant will not be liable for any rent until the date possession is delivered.

5.2 If Landlord is unable to deliver possession, Landlord will not be liable for any damage, nor will this lease terminate.

5.3 Tenant may terminate this lease if Landlord fails to deliver possession within five days of commencement.

5.4 Only the above-named Tenant(s) are to occupy the premises.

5.5 Tenant will not assign this lease agreement or sublet, or have boarders or lodgers.

5.6 Tenant(s) will have no more than ______ guests staying the greater of no more than 10 consecutive days or 20 days in a year.

5.7 Except as noted in an addendum, Tenant agrees the premises, fixtures, appliances and furnishings are in satisfactory and sanitary condition. [See **ft** Form 561]

5.8 Landlord to make any necessary repairs as soon as possible after notification by Tenant. If Landlord does not timely make necessary repairs, Tenant may have the repairs made and deduct the cost, not to exceed one month's rent.

6. TENANT AGREES:

6.1 To comply with all building rules and regulations and later amendments or modifications.

6.2 To pay for the following utilities and services: ____
____
____

a. Landlord to provide and pay for: ____.

6.3 To keep the premises clean and sanitary and to properly dispose of all garbage and waste.

a. ☐ Yard maintenance included in tenant obligations.

6.4 To properly operate all electrical, gas and plumbing fixtures and pipes, and keep them clean and sanitary.

6.5 To make the premises available on 24 hours' notice for entry by Landlord to make necessary repairs, alterations or services, or to exhibit the premises to prospective purchasers, tenants, employees or contractors.

a. In case of emergency or Tenant's abandonment of premises, Landlord may enter the premises at any time.

6.6 Not to disturb, annoy, endanger or interfere with other occupants of the building or neighboring buildings.

6.7 Not to use the premises for any unlawful purpose, violate any government ordinance, or create a nuisance.

6.8 Not to destroy, damage or remove any part of the premises, equipment or fixtures or commit waste, or permit any person to do so.

— — — — PAGE TWO OF THREE — FORM 550 — — — —

— — — — PAGE THREE OF THREE — FORM 550 — — — —

6.9 Not to keep pets or a waterbed on the premises without Landlord's written consent.

a. See attached ☐ Pet Addendum [See **ft** Form 563], ☐ waterbed addendum. [See **ft** Form 564]

6.10 Not to make any repairs, alterations or additions to the premises without Landlord's written consent.

a. Any repairs or alterations shall become part of the premises.

6.11 Not to change or add a lock without written consent.

6.12 Smoking is prohibited in the following area(s) ____
____

7. GENERAL PROVISIONS:

7.1 Tenant agrees to indemnify and hold Landlord harmless from claims, demands, damages or liability arising out of the premises caused by or permitted by Tenant, Tenant's family, agents, employees and guests.

a. ☐ Tenant to obtain insurance for this purpose naming Landlord as an additional insured.

7.2 Landlord to maintain the premises and common areas in a safe and sanitary condition and comply with all applicable ordinances and regulations.

7.3 Waiver of a breach of any provision does not constitute a waiver of any subsequent breach. Landlord's receipt of rent with knowledge of Tenant's breach does not waive Landlord's right to enforce the breached provision.

7.4 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

7.5 **Notice:** Pursuant to Calif. Penal Code §290.46, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

7.6 ☐ See attached addendum for additional terms and conditions. [See **ft** Form 250]

7.7 ☐ See attached Agency Law Disclosure — Real Estate Agency Relationship (mandated if lease term exceeds one year). [See **ft** Form 305]

8. ____
____
____
____
____

I agree to let on the terms stated above.	**I agree to occupy on the terms stated above.**
Date:____________, 20______	Date:____________, 20______
Landlord: ______________________	Tenant: ______________________
Agent: ______________________	
	Signature: ______________________
	Tenant: ______________________
Signature: ______________________	
	Signature: ______________________
Address: ______________________	Address: ______________________
______________________	______________________
Phone: ______________________	Phone: ______________________
Fax: ______________________	Fax: ______________________
Email: ______________________	Email: ______________________

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Rent is, however, subject to adjustments for future inflation.

Also, landlords offer lower rents on leases to persuade tenants to commit themselves to longer periods of tenancy. A landlord entices tenants to enter into lease agreements as part of a strategy to stabilize his income, reduce the vacancy rate and minimize turnover costs.

However, during market periods of generally high vacancy rates, price-competitive landlords favor using month-to-month rental agreements rather than leases. Therefore, when rents begin to rise landlords can adjust rents accordingly.

Just as a month-to-month rental agreement can be terminated on 30 days' notice, the amount of rent can be increased to current market rates on 30 days' written notice (except for a 60- day notice to increase rents on residential units by 10% or more within a 12-month period, and for rent control properties). [CC §827]

Lease negotiations on expiration

Conversely, a landlord cannot alter the terms of a lease agreement during the life of the lease without consideration and the tenant's consent.

The landlord desiring to keep the tenant with an impending lease expiration should contact the tenant and offer to enter into another lease agreement or a month-to-month rental agreement. Unless contacted (and the lease is renewed or extended), the tenant knows he is expected to vacate the premises on expiration of the lease.

If the tenant desires to remain in possession when his lease expires, the amount of rent a landlord can demand is limited only by negotiations and the availability of other rentals and tenants.

On expiration of a lease, the tenant has no lawful right to possession of the unit. If the tenant remains in possession and refuses to pay the amount of rent demanded by the landlord, he may be evicted immediately without further demand for possession. [Calif. Code Civil Procedures §1161(1)]

A better initial plan for retaining tenants includes the landlord entering into a lease agreement, giving the tenant an option to renew or extend the lease for a set period of months at the **prevailing rent**.

Requisites to accepting tenants

On locating a prospective tenant for a residential unit, the landlord requires him to complete a credit application so the prospect's creditworthiness can be established before entering into either a rental or lease agreement. [See **first tuesday** Form 302]

The credit application should be referenced and attached as an addendum to any rental or lease agreement entered into by the landlord and tenant. The application is part of the leasing process which persuades the landlord to accept the applicant as a tenant.

Initially, the landlord uses the authorization provided by the tenant on the application to verify the tenant's rental history, employment, credit standing and check writing history.

If a prospective tenant has a poor credit rating or no credit rating at all, yet meets the landlord's income requirements, the landlord might seek assurances in addition to the maximum security deposit allowed, such as:

- a co-signer on the lease; or
- a guarantee agreement executed by a creditworthy individual. [See **first tuesday** Form 553-1]

Then, if the tenant defaults in rent payments or damages the premises, the landlord can hold the co-signer liable or collect his losses from the guarantor should the security deposit prove insufficient to cover lost rents and maintenance charges.

Condition of premises addendum

Residential landlords and tenants have a statutory duty to, respectively, maintain the property and refrain from damaging the premises. [CC §§1941; 1941.2]

To avoid disputes over who is responsible for any damage to the premises, the residential landlord and tenant should complete and sign a *condition of premises addendum* **before** the tenant is given possession. [See **first tuesday** Form 560]

Before a tenant takes possession, the landlord or his manager needs to inspect the unit with the tenant, called a *walk-through*. Together, the landlord (or resident manager) and the tenant will use a condition of premises addendum to confirm:

- the premises is in satisfactory condition;
- if there is any existing damage to the premises; and
- if there are any repairs the landlord is to make to the premises.

If the unit is furnished, the landlord and tenant will complete and sign an additional form on their walk-through called a *condition of furnishings addendum and inventory*. [See **first tuesday** Form 561]

The **condition of furnishings addendum** confirms:

- the inventory of furnishings located in the unit;
- the current condition of the furnishings; and
- the tenant's acceptance of the furnishings.

At the pre-expiration inspection to be provided residential tenants, the originally prepared condition of premises form is reviewed to help establish tenant responsibility for excess wear and tear to the unit rented.

Pet addendum

Generally, a lease agreement or month-to-month rental agreement prohibits a tenant from keeping pets on the premises.

Some landlords do allow pets, but often:

- impose restrictions on the type or size of the pet; and
- require the landlord's written consent to keep the pet on the premises. [See **first tuesday** Form 551 §5.9 and Form 550 §5.9]

Editor's note — A landlord cannot prohibit a disabled person from keeping a dog on the premises which is specially trained to assist the person. [CC §54.1(b)(5)]

The landlord and tenant can sign and attach a pet addendum that states:

- the type of pet and its name;
- the security deposit to be charged for the pet; and
- the tenants agreement to hold the landlord harmless for any damage caused by the pet. [See **first tuesday** Form 563]

Waterbed addendum

Lease agreements and month-to-month rental agreements also prohibit a tenant from keeping a waterbed or other liquid-filled furnishings on the premises without the landlord's written consent. [See **first tuesday** Form 551 §5.9 and Figure 1, **first tuesday** Form 550 §5.9]

When a tenant has a waterbed, the landlord should require the tenant to sign a *waterbed addendum*. [See **first tuesday** Form 564]

The **waterbed addendum** indicates:

- the additional security deposit the tenant will be required to provide for keeping a waterbed on the premises; and
- the tenant's agreement to maintain an insurance policy to cover potential property damage should the waterbed leak or burst.

Brokerage fee addendum

A broker who is retained under an exclusive authorization to lease property is due a fee if the landlord rents the premises to a tenant during the listing period. [See **first tuesday** Form 110]

Likewise, a broker is entitled to a fee when a tenant has retained the broker under an exclusive authorization to locate space and the tenant rents space during the listing period. If the tenant does not provide for the landlord to pay the fee, the tenant will owe the broker the fee. [See **first tuesday** Form 111]

PET ADDENDUM

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

DATE: ____________, 20_____, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following:

☐ Residential lease agreement

☐ Residential rental agreement

☐ ____

1.1 ☐ of the same date, or dated ____________, 20_____,

1.2 entered into by ____, as the Landlord, and

____ , as the Tenant,

1.3 regarding real estate referred to as ____.

2. The above referenced agreement prohibits pets without Landlord's prior written consent.

AGREEMENT:

3. Landlord agrees Tenant may keep the following pet:

____

____.

4. Landlord hereby acknowledges receipt of $______________ as a security deposit, from which Landlord may offset any expenses or losses caused by the pet. On termination of the above referenced agreement, the security deposit shall be refunded to Tenant with an itemization of its disposition.

5. Tenant agrees:

5.1 Pet will not damage premises or annoy, endanger or inconvenience other tenants.

5.2 Tenant shall hold Landlord harmless for any damages caused by the pet.

5.3 To comply with all laws pertaining to the keeping and leashing of the pet.

5.4 Pet is not known to be dangerous or to have injured individuals.

5.5 ____

____

____

____

____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:____________, 20_____	Date:____________, 20_____
Landlord/Agent:______________________	Tenant:______________________
Signature: ______________________	Signature: ______________________
	Signature: ______________________

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However, brokers often fail to insist on a written fee agreement from either the landlord or the tenant before rendering services. To be assured a fee when a prior written fee agreement does not exist, the broker should include a fee agreement as part of an offer to lease or letter of intent, lastly as an addendum to the proposed rental or lease agreement prepared for the tenant to sign. [See **first tuesday** Form 273]

Other addenda

Other information handed to a residential tenant which is made a part of a rental or lease agreement includes:

- house or building rules; and
- any rent control disclosures required by local rent control ordinances.

Also, a tenant entering into a lease agreement may have negotiated for an option to renew or extend the lease when it expires. Provisions for the option to renew or extend would be included in an addendum attached to the lease agreement. [See **first tuesday** Form 565]

A residential landlord seeking to sell the property may grant the tenant an option to purchase the property. [See **first tuesday** Form 161]

However, no portion of the option money or rent should ever be applied to the purchase price. When the terms of the lease agreement or option agreement provide for any credit to be applied toward the purchase price, or to a down payment on the purchase price, the tenant has acquired an *equitable ownership* interest in the property.

A transaction involving a lease and a purchase option calling for rent or option money payments to be applied toward the purchase price is called a *lease-option sale*, and is a sale of the property.

Terms of residential occupancy

On executing a residential lease agreement or month-to-month rental agreement, a landlord conveys the right to possession of the unit to a tenant, called a *leasehold estate*, or simply a *lease*.

Also, a lease agreement or month-to-month rental agreement sets forth the respective rights and obligations of the landlord and tenant for the use, care and maintenance of the property during the tenants occupancy.

A **security deposit** is usually received from the tenant to cover the cost to clean the unit or remedy any damage caused to the unit by the tenant beyond reasonable wear and tear. [See Figure 1, **first tuesday** Form 550 §1; see Chapter 79]

In return for the use and possession of the premises, the tenant pays the landlord **rent** until expiration of the lease, or periodic tenancy, and possession is then returned to the landlord.

The tenant agrees to pay a **late charge** if rent is not paid within a fixed period of time after it is due, called a *grace period*. [See Figure 1, **first tuesday** Form 550 §3]

Also, the number of **guests** the tenant may have in his unit and the period of time over which his guests may visit is limited. [See Figure 1, **first tuesday** Form 550 §4.6]

The tenant agrees to comply with all building or project **rules** and **regulations** established by CC&Rs or the landlord. [See Figure 1, **first tuesday** Form 550 §5.1]

The landlord and tenant agree who will pay or how they will share the financial responsibility for the unit's **utilities**. Landlords of apartment buildings or complexes often retain the responsibility of providing water to the units. [See Figure 1, **first tuesday** Form 550 §5.2]

In both a rental and lease agreement, the tenant agrees to hold the landlord harmless from all liability for damages caused by the tenant or his guests. [See Figure 1, **first tuesday** Form 550 §6.1]

Statutory rights and duties

Residential lease agreements and month-to-month rental agreements often contain provisions that restate the landlord's and tenant's statutory rights and duties.

For example, the rental agreement reiterates the landlord's statutory obligation to furnish a tenant with:

- a security deposit refund;
- notice of the right to a joint pre-expiration inspection of the unit and delivery of an itemized statement of repairs/cleaning; [CC 1950.5(f)] and
- a statement of security deposit accounting within 21 days after the tenant vacates which itemizes any deductions. [CC 1950.5(g)(1); see Figure 1, **first tuesday** Form 550 §1.4; see Chapter 79]

Also, rental agreements often advise tenants of their limited statutory right to make necessary repairs to the premises and deduct the cost from the rent should the landlord fail to make the repairs that were noticed by the tenant. [CC 1942; see Figure 1, **first tuesday** Form 550 §6.2]

A rental or lease agreement may prohibit a tenant from:

- using the premises for an unlawful purpose;
- creating a nuisance; and
- committing waste. [See Figure 1, **first tuesday** Form 550 §5.7, §5.8]

More importantly, a tenant who uses the premises for the above purposes may be evicted with a 3-day written notice to quit. [CCP 1161(4)]

Chapter 78 Nonresidential lease agreements

This chapter establishes a nonresidential lease agreement as the conveyance of a leasehold interest in real estate.

For a further discussion of this topic, see Chapter 41 of Real Estate Property Management.

Chapter 78 Outline

Chapter 78 Terms

Ad valorem taxes	*Holdover tenant*
Attorney fee provision	*Lease*
Bona fide purchaser	*Leasehold estate*
Breach	*Net lease*
Choice-of-law provision	*Reversionary interest*
Eminent domain	*Statute of frauds*
Forfeit	*Surrender*
Gross lease	*Triple-net lease*

The conveyance of a leasehold

A lease agreement is a **contract** entered into by a landlord and tenant for payment of money and care of real estate. The lease agreement also acts to **convey a possessory interest** in real estate, called a *leasehold estate*, or simply a *lease*. [Calif. Civil Code §761(3)]

By entering into a lease agreement and delivering up possession to the tenant, the landlord conveys to the tenant the *exclusive right to occupy* a parcel of real estate, or space in a parcel, for a fixed period of time. The continued right to occupancy of the real estate, the lease, **is conditioned** on the tenant's performance under provisions in the lease agreement, the contract, calling for the payment of rent and maintenance of the property delegated to the tenant.

On **expiration** of the term of the lease, the right of possession to the real estate reverts to the landlord. During the term of the lease, the landlord, as the fee owner, holds only a *reversionary interest* in the leased parcel or space.

When the lease agreement has been entered into and the tenant takes occupancy, the landlord's and tenant's **right to possession** of the leased real estate is controlled by landlord/tenant law, not contract law.

On the other hand, the rent provisions in the lease agreement **evidence the debt** the tenant has contracted to pay to the landlord over the term of the lease. The lease agreement also contains other contractual provisions establishing the responsibilities of the tenant or landlord to pay the operating costs and provide for the **care and maintenance** of the property.

The landlord may prematurely regain possession of the real estate by **forfeiting**, or terminating, the tenant's leasehold interest and right to possession, if the tenant fails to comply with, or **breaches**, provisions of the lease agreement. Under a declaration of forfeiture in a 3-day notice, the failure prior to expiration of the tenancy to either pay rent, maintain the property, or fully perform under some other material provision in the lease agreement, terminates the tenant's right to possession.

However, on forfeiture of the right to possession, the lease agreement **remains uncancelled** and in effect as a contract requiring the tenant to pay rent and other amounts for the duration of the original term of the lease.

Conversely, the tenant's obligation to pay can be canceled prior to expiration of the term of the lease by a misunderstanding of the forfeiture provision in the notice to quit and the landlord's conduct, called a *surrender*. [**Desert Plaza Partnership** v. **Waddell** (1986) 180 CA3d 805]

Validity of the lease agreement

A lease agreement conveying a term of occupancy exceeding one year must be written to be enforceable, a requirement of the *statute of frauds*. [CC §1624(a)(3)]

The provisions contained in a written lease agreement fall into one of three categories of activities:

- **conveyance** of the leasehold interest;
- the *lease debt*, called *rent*; and
- responsibility for **care and maintenance** of the leased premises. [See Figure 1, **first tuesday** Form 552]

Figure 1

first tuesday *Form 552 -*
Nonresidential Lease Agreement
Commercial, Industrial or Office

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NONRESIDENTIAL LEASE AGREEMENT
Commercial, Industrial or Office

Prepared by: Agent ______________ **Phone** ______________
Broker ______________ **Email** ______________

DATE: ____________, 20_____, at ______________________________, California.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 ______________________________, as the Landlord, leases to ______________________________, as the Tenant, real estate referred to as ______________________________.

1.2 Landlord acknowledges receipt of $____________ to be applied as follows:
☐ Security deposit $____________ ☐ First month's rent $____________
☐ Last month's rent $____________

1.3 The following checked addendums are made a part of this nonresidential lease:
☐ Addendum — General Use [See **ft** Form 250]
☐ Authority to Sublease/Assign
☐ Brokerage Fee Addendum [See **ft** Form 273]
☐ Condition of Premises Addendum [See **ft** Form 560]
☐ Occupant's Operating Expense Sheet [See **ft** Form 562]
☐ Property Description
☐ Option to Renew/Extend Lease [See **ft** Form 565]
☐ Standard Option to Purchase [See **ft** Form 161]
☐ Option to Lease Additional Space
☐ Building rules ☐ Plat of leased space
☐ ______________

2. TERM OF LEASE:

2.1 The lease commences ____________, 20_____, and expires ____________, 20_____.
a. The month of commencement is the anniversary month.

2.2 The lease terminates on the last day of the term without further notice.

2.3 If Tenant holds over, Tenant to be liable for damages at the daily rate of $____________.

2.4 ☐ This lease agreement is a sublease of the premises which is limited in its terms by the terms and condition of the attached master lease.

3. RENT:

3.1 Tenant to pay rent monthly, in advance, on the first day of each month, including rent for any partial month pro rated at 1/30th of the monthly rent per day.

3.2 ☐ Monthly rent for the entire term is fixed at the amount of $____________.

3.3 ☐ Monthly rent, from year to year, is graduated on each anniversary month as follows:
Initial year's monthly rent to be $____________, and
a. _____% increase in monthly rent over prior year's monthly rent; or
b. First anniversary monthly rent . . . . $____________
Second anniversary monthly rent . . . . $____________
Third anniversary monthly rent . . . . $____________
Fourth anniversary monthly rent . . . . $____________

3.4 ☐ Monthly base rent for the initial 12 months of the term is the amount of $____________, adjusted annually on the first day of each anniversary month by increasing the initial monthly base rent by the percentage increase between the applicable Consumer Price Index for All Urban Consumer (CPI-U) figures published for the third month preceding the month of commencement and the third month preceding the anniversary month.
a. The applicable CPI-U Index (1982-1984 = 100) is:
☐ Los Angeles-Anaheim-Riverside, ☐ San Francisco-Oakland-San Jose,
☐ San Diego, ☐ National, ☐ ______________________________.
b. Rent increases under CPI-U adjustments are limited for any one year to an increase of _____%.
c. On any anniversary adjustment, should the CPI-U have decreased below the CPI-U for the prior twelve-month period, the monthly rent for the ensuing 12 months shall remain the same as the rent during the prior 12 months.
d. If the CPI-U is changed or replaced by the United States Government, the conversion factor published by the Government on the new Index shall be used to compute annual adjustments.

3.5 ☐ Additional percentage rent equal to _____% of gross sales made from the premises during each calendar year, less credit for other rent, real estate taxes, insurance and common area maintenance (CAM) charges paid for the calendar year.
a. The percentage rent shall be computed and paid for each month of the lease with a signed written statement of the gross income and percentage computation by the tenth day of the following month.

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b. The additional percentage rent payable monthly to be credited for other rent, taxes, insurance, and CAMs paid by Tenant for the month.
c. Within one month after each calendar year and on expiration of the lease, Tenant shall compute and deliver a written statement of sales and the percentage rent due for the calendar year, less credit for rent, taxes, insurance and CAMs paid for the calendar year, to annually adjust the percentage rent remaining due from Tenant or to be refunded to Tenant by Landlord, which difference will be paid on delivery of the annual statement.
d. Gross sales includes all money or equivalent received by Tenant, subtenant, licensees or concessionaires, in the ordinary course of business, whether wholesale or retail, cash or credit, less credit for goods returned by customer or merchandise returned by Tenant or transferred to tenant-affiliated stores. ______________________________
e. Landlord has the right, on reasonable notice, to audit Tenant's books regarding sales information.

3.6 ☐ Every _____ years after commencement, including extensions/renewals, the monthly base rent to be adjusted, upward only, to current market rental rates for comparable premises, and computation of any future CPI-U adjustments will treat the year of each current market adjustment as a commencement year for selecting the Index figures.
a. The monthly rent during any year shall not be less than the previous year's monthly rent.
b. Landlord to reasonably determine and advise Tenant of the adjusted rental rates prior to three months before the adjustment becomes effective.

3.7 Rent to be paid by:
a. ☐ check, ☐ cash, or ☐ cashier's check, made payable to Landlord.
Personal delivery of rent to be at Landlord's address during the hours of _____ to _____ on the following days: ______________________________.
b. ☐ credit card #_____/_____/_____/_____ issued by ______________________________, ______________ which Landlord is authorized to charge each month for rent due.
c. ☐ deposit into account number ______________________________
at ______________________________ (Financial Institution)
______________________________ (Address)
d. ☐ ______________________________.

3.8 Tenant to pay a charge of $____________ as an additional amount of rent, due on demand, in the event rent is not received within five days of the due date.

3.9 If any rent or other amount due Landlord is not received within five days after its due date, interest will thereafter accrue on the amount at 12% per annum until paid. On receipt of any past due amount, Landlord to promptly make a written demand for payment of the accrued interest which will be payable within 30 days of the demand.

3.10 Tenant to pay a charge of $____________ as an additional amount of rent, due on demand, for each rent check returned for insufficient funds, and thereafter to pay rent by cash or cashier's check.

4. OPERATING EXPENSES:

4.1 Tenant is responsible for payment of utility and service charges as follows: ______________________________.

4.2. Landlord is responsible for payment of utility and service charges as follows: ______________________________.

4.3 Tenant to pay all taxes levied on trade fixtures or other improvements Tenant installs on the premises.

4.4 Should Landlord pay any charge owed by Tenant, Tenant shall pay, within 10 days of written demand, the charge as additional rent.

4.5 As additional rent, Tenant to pay _____% of all real property taxes and assessments levied by governments, for whatever cause, against the land, trees and building containing the leased premises, within 30 days after written computation and demand from Landlord.

4.6 As additional monthly rent, Tenant to pay _____% of the common area maintenance (CAM) incurred each month, within 10 days of written statement and demand for payment.
a. Common area maintenance is the cost of maintaining and operating the "Common Areas," including all sidewalks, corridors, plazas, hallways, restrooms, parking areas, interior and exterior walls and all other open areas not occupied by tenants.
b. Common area maintenance includes "all charges" for garbage removal, janitorial services, gardening, landscaping, printing/decorating, repair and upkeep, utilities and other operating costs, including charges for property management of the common area maintenance.

5. POSSESSION:

5.1 Tenant may terminate the lease if Landlord does not deliver up possession within 10 days after commencement of the lease.

5.2 Landlord is to recover and deliver possession of the premises from the previous tenant. Tenant will not be liable for rent until possession is delivered.

PAGE TWO OF FOUR — FORM 552

Figure 1, cont'd

first tuesday *Form 552 - Nonresidential Lease Agreement Commercial, Industrial or Office*

5.3 If Landlord is unable to deliver possession of the premises, Landlord will not be liable for any damages.

6. USE OF THE PREMISES:
6.1 The Tenant's use of the premises shall be ______________________________
6.2 No other use of the premises is permitted.
a. Tenant may not conduct any activity which increases Landlord's insurance premiums.
6.3 Tenant will not use the premises for any unlawful purpose, violate any government ordinance or building and tenant association rules, or create any nuisance.
6.4 Tenant shall deliver up the premises together with all keys to the premises on expiration of the lease in as good condition as when Tenant took possession, except for reasonable wear and tear.

7. APPURTENANCES:
7.1 Tenant shall have the right to use Landlord's access of ingress and egress.
7.2 Tenant shall also have the use of ______________ parking spaces for the running of its business.

8. SIGNS AND ADVERTISING:
8.1 Tenant will not construct any sign or other advertising on the premises without the prior consent of Landlord.
8.2 ☐ Landlord will maintain a directory in the lobby of the premises displaying the name and suite number of Tenant. Landlord has the right to determine the size, shape, color, style and lettering of the directory.
8.3 ☐ Landlord will provide a sign to be placed on the primary door to Tenant's suite. The fees for the cost and installation will be paid by Tenant.

9. TENANT IMPROVEMENTS/ALTERATIONS:
9.1 Tenant may not alter or improve the real estate without Landlord's prior consent.
a. Tenant will keep the real estate free of all claims for any improvements and will timely notify Landlord to permit posting of Notices of Nonresponsibility.
9.2 Any increases in Landlord's property taxes caused by improvements made by Tenant shall become additional rent due on demand.

10. REPAIR AND MAINTENANCE:
10.1 The premises are in good condition, except ☐ as noted in an addendum. [See **ft** Form 250]
10.2 Tenant shall maintain and repair the premises, except for the following which are Landlord's responsibility: ☐ Plumbing and sewers, ☐ Structural foundations, ☐ Exterior walls, ☐ Heating and air conditioning, ☐ Store front, ☐ Plate glass, ☐ Roof, ☐ Parking areas, ☐ Lawns and shrubbery, ☐ Sidewalks, ☐ Driveways/right of ways, ☐ Electrical, ☐ ______________________________

11. RIGHT TO ENTER:
11.1 Tenant agrees to make the premises available on 24 hours notice for entry by Landlord for necessary repairs, alterations, or inspection of the premises.

12. WASTE:
12.1 Tenant will not destroy, damage, or remove any part of the premises or equipment, or commit waste, or permit any person to do so.

13. LIABILITY INSURANCE:
13.1 Tenant shall obtain and maintain commercial general liability and plate glass insurance covering both personal injury and property damage to cover Tenant's use of the premises insuring Tenant and Landlord.
13.2 Tenant shall obtain insurance for this purpose in the minimum amount of $______________.
13.3 Tenant shall provide Landlord with a Certificate of Insurance naming Landlord as an additional insured. The Certificate shall provide for written notice to Landlord should a change or cancellation of the policy occur.
13.4 Each party waives all insurance subrogation rights it may have.

14. FIRE INSURANCE:
14.1 Tenant shall obtain and maintain a standard fire insurance policy with extended coverage for theft and vandalism to the extent of 100% of the replacement value of all personal property and the restoration of Tenant improvements.

15. HOLD HARMLESS:
15.1 Tenant shall hold Landlord harmless for all claims, damages or liability arising out of the premises caused by Tenant or its employees or patrons.

16. DESTRUCTION:
16.1 In the event the premises are totally or partially destroyed, Tenant agrees to repair the premises if the destruction is caused by Tenant or covered by its insurance.
16.2 The lease shall not be terminated due to any destruction.
16.3 Landlord shall repair the premises if the cause is not covered by Tenant's insurance and is covered by Landlord's policy.
16.4 Landlord may terminate the lease if the repairs cannot be completed within 30 days, the cost of restoration exceeds 70% of the replacement value of the premises, the insurance proceeds are insufficient to cover the actual cost of the repairs, or the premises may not be occupied by law.

17. SUBORDINATION:
17.1 Tenant agrees to subordinate to any new financing secured by the premises which does not exceed 80% loan-to-value ratio, and interest of 2% over market, and not less than a 15-year monthly amortization and five-year due date.

18. TENANT ESTOPPEL CERTIFICATES:
18.1 Within 10 days after notice, Tenant will execute a certificate stating the existing terms of the lease to be provided to prospective buyers or lenders.
18.2 Failure to deliver the certificate shall be conclusive evidence the information contained in it is correct.

19. ASSIGNMENT, SUBLETTING AND ENCUMBRANCE: [Check only one]
19.1 ☐ Tenant may not assign this lease or sublet any part of the premises, or further encumber the leasehold.
19.2 ☐ Tenant may not transfer any interest in the premises without the prior consent of Landlord.
a. ☐ Consent may not be unreasonably withheld.
b. ☐ Consent is subject to the attached conditions. [See **ft** Form 250]

20. SURRENDER:
20.1 Tenant may surrender this lease only by a written cancellation and waiver agreement with Landlord.

21. EMINENT DOMAIN:
21.1 Should a portion or all of the premises be condemned for public use, Landlord may terminate the lease and Tenant's possession. If the lease is not terminated, Tenant shall receive a rent abatement for the actual reduction (if any) in the value of the lease.
21.2 Tenant waives the right to any compensation awarded from the condemning authority for the whole or partial taking of the premises.
21.3 Any Tenant's damages shall come solely from the condemning authority.

22. WAIVER:
22.1 Waiver of a breach of any provision in this lease shall not constitute a waiver of any subsequent breach. Landlord's receipt of rent with knowledge of Tenant's breach does not waive Landlord's right to enforce the breach.

23. DEFAULT REMEDIES:
23.1 If Tenant breaches any provision of this lease, Landlord may exercise its rights, including the right to collect future rental losses after forfeiture of possession.

24. BROKERAGE FEES:
24.1 ☐ Landlord and Tenant to pay Broker fees per the attached schedule of leasing agent's fee. [See **ft** form 113]

25. MISCELLANEOUS:
25.1 ☐ See attached addendum for additional terms. [See **ft** Form 250]
25.2 In any action to enforce this agreement, the prevailing party shall receive attorney fees.
25.3 This lease shall be binding on all heirs, assigns and successors except as provided in §19.
25.4 This lease shall be enforced under California law.
25.5 This lease reflects the entire agreement between the parties.
25.6 ☐ This lease agreement is secured by a trust deed. [See **ft** Form 451]
25.7 ☐ The performance of this lease is assured by a guarantee agreement. [See **ft** Form 439]

I agree to let on the terms stated above.	**I agree to occupy on the terms stated above.**
Date:____________, 20______	Date:____________, 20______
Landlord: ______________________	Tenant:______________________
Agent: ______________________	
	Signature: ______________________
Signature: ______________________	Tenant:______________________
Address: ______________________	
______________________	Signature: ______________________
Phone:______________Cell: ____________	Address: ______________________
Fax: ______________________	______________________
Email: ______________________	Phone:______________Cell: ____________
	Fax: ______________________
	Email: ______________________

FORM 552 03-11

To be valid, a lease agreement must:

- designate the **size and location** of the leased premises with *reasonable certainty*;
- set forth a **term** for the tenancy conveyed; and
- state the **rental amount**, and its time, place and manner of payment. [**Levin** v. **Saroff** (1921) 54 CA 285]

Here, the tenant will participate in the condemnation award since he owns a leasehold (estate) interest in the property that was not limited by agreement. The written agreement entered into by the landlord and the tenant — an offer to lease on the terms stated — becomes the lease agreement when the tenant takes possession of the premises without entering into a formal lease agreement. [**City of Santa Cruz** v. **MacGregor** (1960) 178 CA2d 45]

To record or not to record

A lease agreement need not be recorded. Between the landlord and the tenant, and all other parties who have *knowledge* of the lease, the agreement is enforceable whether or not it is recorded. [CC §1217]

Thus, an unrecorded lease agreement with a term exceeding one year in length is only void as against a *bona fide purchaser (BFP)*. [CC §1214]

To qualify as a BFP, the buyer or lender must lack **knowledge** that the lease agreement exists or a tenant is in possession, and purchase the leased real estate for valuable consideration or accept the real estate as security for a debt.

However, when a tenant occupies the property at the time it is purchased or further encumbered, the purchaser or secured lender is **charged with knowledge** of the tenant's leasehold interest — whether or not the lease agreement is recorded. Thus, the tenant's occupancy puts the purchaser and lender on **constructive notice** a lease (or some other arrangement with the occupant) exists. [**Manig** v. **Bachman** (1954) 127 CA2d 216]

However, when a lease agreement is recorded, the content of the recorded agreement may be relied on by a purchaser or lender as containing **all the rights** of the tenant. The need for a tenant estoppel certificate to establish the tenant's rights in the property is eliminated by the recording.

*Editor's note — An unrecorded option held by a tenant to buy the leased property or extend the lease cannot be enforced against a buyer or lender who later acquires an interest in the property when the **lease agreement is recorded**, if*:

- *the buyer or lender have no actual knowledge of the option;*
- *the option to extend the lease or buy the property itself is not recorded; and*
- *the unrecorded options are not referenced in the recorded lease. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]*

The contents of a lease agreement

A nonresidential lease agreement form has five main sections:

- **identification** of the parties and the premises, and the conveyance and term of the lease;
- the **rent** and terms for payment of amounts owed;
- the **care and maintenance** of the leased property;
- **miscellaneous provisions** for circumstances peculiar to the transaction; and
- the **signatures** of the parties.

The **identification section** of a real estate lease agreement includes:

- the names of the landlord and the tenant;
- a description of the leased premises;
- words of conveyance of the leased property;
- a receipt for prepaid rents and the security deposit; and
- a list of the addenda which contain exhibits or additional terms. [See Figure 1, **first tuesday** Form 552 §1.3]

The leasehold conveyance

The lease agreement includes words of transfer by which the landlord conveys a leasehold interest (lease) in the property to the tenant upon signing the agreement and delivery of possession to the tenant. [See Figure 1, **first tuesday** Form 552 §1.1]

The **conveyance** of a lease is typically achieved with the words "landlord . . . **leases to** . . . tenant the real estate referred to as . . ." [See Figure 1, **first tuesday** Form 552 §1.1]

Proper identification of the parties

Each party to a lease agreement must be properly identified. On the lease agreement form, the identification of the tenant should indicate how his ownership of the lease conveyed will be vested, such as community property, community property with right of survivorship, joint tenancy, tenancy-in-common, sole ownership, as a trustee for himself or for someone else, or as a business entity.

When the ownership interest of the landlord is community property, both spouses must consent to agreements leasing the community property for a fixed term exceeding one year. If not, the community is not bound by the lease agreement, and, if challenged within one year after commencement by the nonconsenting spouse, the tenant cannot enforce the conveyance of the lease. [Calif. Family Code §1102]

Business entities, excluding DBAs, individuals and their trusts, that own or lease property include:

- corporations and out-of-state entities qualifying as a corporation such as business trusts;
- limited liability companies (LLCs);
- partnerships, general or limited;
- real estate investment trusts (REITs);
- nonprofit organizations; and
- governmental agencies.

When the landlord or tenant is a partnership, the lease agreement should indicate:

- whether the partnership is a limited, general or limited liability partnership (LLP);
- the partnership's state of formation, and if out of state, whether it is qualified to do business in California; and
- the name of the partner(s) authorized to bind the partnership.

With information on the partnership, the landlord and any title company insuring the leasehold can confirm through a review of recorded documents the authority of the general or managing partner to bind the partnership, such as an LP-1 for a limited partnership, or the managing member to bind an LLC.

Whether a corporation is the landlord or tenant, the full corporate name and the state of incorporation must be disclosed, as well as the name and title of the officer who will be signing the lease agreement.

The corporate information, along with a *resolution* from the board of directors authorizing the corporate officers to enter into the lease in the name of the corporation, will allow for confirmation of:

- the corporation's good standing to operate in the state; and
- the officers registered with the state to act on behalf of and bind the corporation under resolution by the corporation's board of directors.

Premises identified with certainty

The nonresidential lease agreement must describe the premises to be leased so the premises can be located with **reasonable certainty**. While the description may not itself be "definite and certain" as worded, an imperfectly worded description to be *reasonably certain* need only furnish a "means or key" for a surveyor to identify the parcel's location on the earth's surface or within a building. [**Beverage** v. **Canton Placer Mining Co.** (1955) 43 C2d 769]

If the premises is a building or a space in a building, the common street address, including the unit number, is a sufficient description to identify the premises.

If the premises is not easily identified by its common address, a plot map or floor plan should be included as an addendum to the lease agreement, with the space to be rented highlighted or otherwise identified. A plot map or floor plan eliminates confusion over the location of the leased parcel or space in the building, and initially establishes the parameters of the leased space.

An attached floor or plot plan noting square footage is useful if rent is calculated based on square footage occupied by the tenant, or on the percentage of square footage within a project leased to the tenant.

Also, an inaccurate or incomplete description of the leased premises will not prevent a landlord from conveying, and the tenant from accepting, a leasehold interest in a parcel of real estate for lack of certainty.

Addenda to the lease agreement

The terms common to all nonresidential leases are contained in the provisions of a regular lease agreement form.

However, the terms and conditions peculiar to the leasing of a particular type of nonresidential tenancy, such as commercial, industrial, office, farming operation or hotel, or provisions unique to the parties and their advisors, should be handled in an addendum attached to the lease agreement.

The use of an addendum to house extraordinary and atypical provisions not in common use avoids the element of a later unpleasant (and litigious) surprise. Extraordinary provisions occasionally go unnoticed at the time the lease agreement is entered into because they are buried in preprinted copy.

Also, any handwritten or typewritten provisions added to an agreement control over conflicting pre-printed or boilerplate provisions. Should inconsistencies arise between provisions in the pre-printed lease agreement and an attached addendum, the provisions in the addendum control. [**Gutzi Associates** v. **Switzer** (1989) 215 CA3d 1636]

The use of addenda for making changes or additions to leasing provisions allows parties to tailor the lease agreement to meet their needs in the transaction, while retaining the integrity of the contents of the lease agreement form.

Addenda occasionally attached to a nonresidential lease agreement include:

- terms unique to the type of property leased;
- a property description addendum, such as a plot map or site plan;
- a structural or tenant improvement agreement;
- a condition of premises addendum [See **first tuesday** Form 560];

- a building rules addendum;
- an option or right of first refusal to renew or extend [See **first tuesday** Form 566];
- a brokerage fee addendum [See **first tuesday** Form 273];
- a tenant leasehold subordination agreement regarding a future loan;
- a non-disturbance and attornment provision;
- a signage or tenant association agreement;
- an option or right of first refusal to lease additional space;
- authority to sublease or assign; and
- an option or right of first refusal to buy. [See **first tuesday** Forms 161 and Form 579]

If the lease agreement is for a sublease of the premises, a copy of the master lease should be attached and noted in the agreement. [See Figure 1, **first tuesday** Form 552 §2.4]

The term of the tenancy

A nonresidential lease agreement is an agreement to rent real estate for a fixed term, conveying a type of leasehold estate called a *tenancy for years*. [CC §761(3)]

The lease agreement should clearly indicate the dates on which the lease term commences and expires. [See Figure 1, **first tuesday** Form 552 §2.1]

Delivery and acceptance of possession are addressed separately from the date of the lease agreement since the transfer of possession operates independently of the date of the lease agreement. [See Figure 1, **first tuesday** Form 552 §5]

On expiration of the lease term on the date stated in the lease agreement, the lease (right to possession) automatically terminates and the tenant must have vacated without further notice by either the landlord or tenant. [CC §1933]

On expiration of a lease, a holdover tenancy, called a *tenancy-at-sufferance*, is created when:

- the tenant remains in possession after the lease term expires; and
- the landlord refuses to accept further rent payments.

The holdover tenancy ends when the tenant vacates or is evicted, or the landlord accepts rent during the holdover period permitting the occupancy.

The lease agreement contains a holdover rent provision calling for a set dollar amount of rent due for each day the tenant holds over. The rent is due and payable when the tenant vacates or is evicted. The daily rent should be significantly higher than the fair market rate, although an excessive amount is unenforceable in a UD action since it is unreasonable. [See Figure 1, **first tuesday** Form 552 §2.3]

If the amount of holdover rent is not set in the lease agreement, a fair market rate will be recoverable during the holdover (which is also the ceiling for rent awarded in a UD action for the holdover).

The landlord can initiate UD proceedings to evict the holdover tenant immediately after the lease expires. [CCP §1161(1)]

However, the landlord who accepts rent for any period of occupancy falling after the lease expires and before the tenant vacates creates a periodic tenancy. To terminate the resulting periodic tenancy, the landlord must serve the tenant with a 30-day notice to vacate the premises before he can evict the tenant. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp 859; see **first tuesday** Form 571]

Delivery and acceptance of possession

Provisions in a lease agreement pertaining to the date for delivery of the leased premises to the tenant address the landlord's failure to deliver up the premises to the tenant. [See Figure 1, **first tuesday** Form 552 §5]

The tenant is given the opportunity to terminate the lease agreement if possession is not delivered within an agreed-to number of days after commencement of the lease.

A landlord sometimes fails to deliver possession to the tenant due to his inability to recover the premises from a previous tenant. To cover the risk, the lease agreement should state the tenant will not be liable for rent payments until possession is delivered. [See Figure 1, **first tuesday** Form 552 §5.2]

Further, the lease agreement should state the landlord will not be liable for damages if he is unable to deliver possession.

Eminent domain

A tenant can contract away his right to receive any compensation awarded to the landlord in a condemnation action. [**New Haven Unified School District** v. **Taco Bell Corporation** (1994) 24 CA4th 1473]

Thus, nonresidential leases drafted by landlords or trade associations typically reserve for the landlord all rights to any condemnation award under the *eminent domain provision*. [See Figure 1, **first tuesday** Form 552 §21]

Also, the landlord may reserve his right to terminate the lease in the event of a partial condemnation. If the landlord does not choose to terminate the lease when a **partial taking** occurs, the tenant is entitled to a rent abatement for the reduction in value of the leasehold interest.

A tenant under a lease has a right to receive compensation for his leasehold interest if his lease is terminated due to a condemnation proceeding. [CCP §1265.150]

Since the lease provisions eliminate the tenant's rights to any compensation awarded to the landlord, the tenant must look to the condemning authority to recover other losses, such as:

- relocation costs;
- loss of goodwill;
- bonus value of the lease (due to below market rent); or
- severance damages if a partial taking occurred.

Brokerage fees

Initially, the responsibility for paying any brokerage fees for leasing services is controlled by employment provisions in an authorization to lease or property management agreement entered into by the tenant or the landlord and their respective brokers.

Second, and of equal effect as a separate underlying fee agreement, is the placement of a brokerage fee provision within the tenant's offer to lease or **letter of intent** signed by the tenant.

Lastly, a provision for payment of the broker fees is included in the lease to allow enforcement in case the broker failed to obtain a prior written commitment from either the tenant or the landlord to pay the leasing agent's fee or to pay fees which will later be earned on lease extensions or purchase of the property by the tenant. [See Figure 1, **first tuesday** Form 552 §24.1 and **first tuesday** Form 113]

Miscellaneous provisions

An *attorney fee provision* is essential in a lease agreement if the landlord is to recover costs incurred to enforce payment of rent or evict the tenant. Regardless of how an **attorney fee provision** is written, the prevailing party, if any, is entitled to his fee. [CC §1717(a); see Figure 1, **first tuesday** Form 552 §25.2]

The *heirs, assigns and successors clause* binds those who later take the position of the landlord or tenant, by grant or assignment (privity of estate), or by an assumption (privity of contract). [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309; see Figure 1, **first tuesday** Form 552 §25.3]

A *choice-of-law provision* assures application of California rules of law should a dispute arise with a tenant regarding the lease. [See Figure 1, **first tuesday** Form 552 §25.4]

Application of California law in disputes over property located in California adds stability to the legal expectations of the landlord and tenant under the lease, produces greater commercial certainty in real estate transactions and stabilizes property values.

Also, the lease agreement must reflect the entire agreement between the parties and should be modified only in writing.

An *entire agreement clause* serves two key purposes. An entire agreement clause limits:

- the tenant's ability to imply terms into the lease based on oral statements **made before entering** into the lease agreement; and

- the **later oral modification** of lease terms and the attendant disputes over "just what are" the terms of the oral modification.

The tenant's performance of lease obligations may also be *secured* by a trust deed encumbering real estate owned by the tenant (or others) or be guaranteed by a corporate user's officer or another person. [See **first tuesday** Form 451; see Figure 1, **first tuesday** Form 552 §§25.6 and 25.7]

If the tenant fails to pay rent or otherwise breaches the lease, the landlord can evict the tenant and, after a demand for payment, foreclose under the performance trust deed to recover rent due under the lease, attorney fees and costs of the trustee's sale. [**Willys of Marin Company** v. **Pierce** (1956) 140 CA2d 826]

Signatures on behalf of the parties

Individuals who sign a lease agreement on behalf of the landlord or the tenant must have the capacity and the authority to act on behalf of and bind the landlord or tenant. [CC §§2304; 2307]

When a corporation enters into a lease, the officers signing the lease agreement are given authority to bind the corporation by a *corporate resolution* from the board of directors of the corporation. [Calif. Corporations Code §300]

Unless the landlord is aware that the persons signing do not have authority to enter into a lease on behalf of the corporation, the lease entered into by a corporate tenant is valid if it is signed by:

- the chairman of the board, president or the vice president; and
- secretary, any assistant secretary, chief financial officer or assistant treasurer. [Corp C §313]

However, a corporate resolution is the best evidence of the corporate officers' authority to act on behalf of the corporate tenant.

When a LLC or LLP enters into a lease agreement, the **manager** signing on behalf of the LLC or LLP to bind the entity to the lease must be the person named as the manager in the LLC-1 or LLP-1 certificate filed with the Secretary of State and recorded with the local county recorder.

However, an LLP or an LLC will be bound to a lease agreement if a partner or member, other than the general partner or manager, signs the lease agreement and the landlord believes the partner or member is acting with the authority of the entity due to their title as chairman or president. [Corp C §17154(c)]

The economics of nonresidential leases

Nonresidential lease agreements are used in transactions involving industrial, commercial, office and other types of nonresidential income-producing property.

A tenant who acquires a leasehold interest in nonresidential real estate agrees to be obligated for none, some or all of the operating costs of the real estate, as rent due in addition to payment of the base rent and periodic adjustments.

Editor's note — A residential lease agreement usually provides for the tenant to assume no care and maintenance responsibilities for the property except for excess wear and tear which may occur during his occupancy.

Typically, the longer the term of the nonresidential lease, the more extensive the shift of ownership costs and responsibilities to the tenant, including:

- property operating expenses;
- all or future increases in real estate taxes, called *ad valorem taxes*;
- hazard insurance premiums;
- repair and maintenance; and
- the risk of an increase in interest payments on an adjustable rate loan encumbering the property.

When a long-term lease obligates the tenant to pay for all expenses incurred in the ownership and operation of the property, the tenant incurs the expenses in one of two ways:

- directly, where the tenant contracts for services and pays the cost, including taxes and insurance premiums; or
- indirectly, when the landlord incurs the expenses and then bills the tenant for payment, such as common area maintenance charges (CAMs).

The responsibility for the payment of operating costs is reflected in the reference to nonresidential leases as **gross** or **net**, with variations on each.

Leasing agents have no universally accepted definitions or guidelines for titles they use to identify the economics of a lease, and the classifications for leases are forever changing. Often, agents must clarify with each other the type of lease their clients intend to enter.

A nonresidential lease is typically called a *gross lease* if the tenant pays for his utilities and janitorial fees, but is not responsible for any other care, maintenance or carrying costs of the property.

In a lease for space in an office building, when the landlord retains the responsibility for payment of all costs of care and maintenance, including the tenant's utilities and janitorial services, the lease used is referred to as a *full- service gross lease*.

Conversely, a nonresidential lease that transfers to the tenant the obligation to pay some or all of the costs and responsibilities of ownership, in addition to utilities and janitorial services, is referred to as a *modified gross lease* or *net lease*.

A lease becomes more **net** (and less gross) for the landlord as he shifts more ownership responsibilities and operating costs to the tenant.

The modified gross or net lease is the most commonly used lease agreement in nonresidential properties, other than for multiple tenant office buildings or large multi-tenant industrial projects.

When a lease passes on the responsibility for all costs and maintenance of the property to the tenant, either directly or through CAMs, leaving the landlord responsible for capital improvements only, such as structural repairs or replacement, the lease is referred to as a *net-net-net* or *triple-net* lease in the industry.

When a tenant assumes absolutely all ownership duties under a lease agreement, and the landlord merely collects rent payments without concern for his management of the property, the lease is called a *pure-net lease*.

Rents and deposits

Chapter 79 — Security deposits and pre-termination inspections

This chapter examines the variety of security deposit rules controlling residential and nonresidential landlords who handle these deposits, and the residential tenant's right to a pre-expiration inspection.

For a further discussion of this topic, see Chapter 19 of Real Estate Property Management.

Chapter 79 Outline

Chapter 79 Terms

Joint pre-expiration inspection
Pet deposit
Pre-expiration inspection statement
Rent
Security deposit
Tenant screening fee
Waterbed administrative fee

Security to cover nonperformance

Both nonresidential and residential landlords traditionally require tenants to deposit funds with the landlord as security, in addition to the first month's rent. [See **first tuesday** Form 550 and 552]

The additional funds provide **security** against the tenant's default on obligations agreed to in the rental or lease agreement. Tenant obligations include paying rent, reimbursing the landlord for expenses incurred due to the tenant's conduct, maintaining the premises during occupancy and returning the premises in the same level of cleanliness as existed at the time possession was initially taken, less ordinary wear and tear.

For **residential rentals**, all monies paid to the landlord in addition to the first month's rent are considered part of the security deposit, except screening fees and waterbed administrative fees.

Security deposits include any funds received for the purpose of covering defaults by the tenant under the rental or lease agreement, regardless of the name given to the funds by the landlord, such as a nonrefundable deposit, cleaning charge or last month's rent. [Calif. Civil Code §§1940.5; 1950.5(b), (c); 1950.6]

Thus, any funds legally recharacterized as a security deposit are **refundable** when the tenant vacates, less deductions for unpaid rent and recoverable costs incurred by the landlord for the repair of damages caused by the tenant.

Also, funds may be deducted from the tenant's security deposit for cleaning to return the premises to the level of cleanliness as when initially leased to the tenant, less wear and tear. [CC §§1950.5(b); 1950.7(c)]

For nonresidential tenancies, security deposit amounts may vary based on the tenant's type of operations and the accompanying risks of damage they pose to the leased property. For instance, a small services firm may pay an amount equal to one month's rent as a security deposit, while a photography studio which uses chemicals in its film processing may be asked to pay an amount equal to two month's rent.

Like all other terms in a nonresidential lease, the amount of the security deposit is negotiable between the nonresidential landlord and the tenant prior to entering into the lease.

In a market downturn, aggressively competitive landlords are less likely to require a security deposit in exchange for maintaining current rental income (occupancy), which exposes them to an increased risk of loss if the tenant defaults.

Unlike nonresidential tenants, residential tenants, as a matter of public policy, are perceived as lacking bargaining power when they negotiate a rental or lease agreement. Thus, limits are imposed by law on the amount of security deposit a residential landlord may require.

The problematic last month's rent

When the availability of unfurnished residential units is tight, residential landlords often require all prospective tenants to advance the maximum permissible amount of rent and security deposit.

In addition to the collection of **one month's advance rent**, the further amount a residential tenant may be required to pay as a **security deposit** to cover defaults is limited to an amount equal to:

- two months' rent for unfurnished units; and
- three months' rent for furnished units. [CC §1950.5(c)]

Landlord's charge maximum amounts upfront in the hopes of eliminating less solvent tenants from renting their units.

On residential rentals, payment of the first and last month's rent is recharacterized as one month's advance rent for the first month of the occupancy and a security deposit equal to the amount paid for the last month's rent, plus any other amounts eligible to be classified as a security deposit. [CC §1950.5(c)]

Nonresidential landlords also typically require an advance payment of both the first and last month's rent on a lease.

Residential deposits: not rent, not fees

A residential landlord must require the same security deposit for all units, such as an amount equal to one month's rent, or base the amount of the security deposit on each tenant's creditworthiness.

Editor's note — If a landlord sets the amount of the security deposit based on a tenant's creditworthiness — the greater or lesser risk of a loss due to a prospective tenant's likely failure to perform on lease provisions — he must establish clear and precise standards for his different levels of creditworthiness (such as credit scoring) and apply each level's standard equally to all prospective tenants who meet that level of credit. Lenders set levels of creditworthiness and charge different rates of interest for each level. [24 Code of Federal Regulations §100.60(b)(4)]

Any money handed to a residential landlord by a tenant on entering into a rental or lease agreement must be **characterized** as one of the following:

- a *tenant screening fee* for processing an application;
- a *waterbed administrative fee*;
- *rent*; or
- a *security deposit*. [CC §§1940.5(g); 1950.5(b); 1950.6(b)]

A residential landlord has limited authority to require an additional **pet deposit** if the tenant is permitted to keep one or more pets in the unit.

However, the total amount of advance funds received from a tenant **with a pet** may not exceed three month's rent for an unfurnished unit or four month's rent for a furnished unit. [CC §1950.5(c)]

Security deposit limitations may be exceeded when a tenant maintains a **waterbed on the premises**.

The residential landlord of an unfurnished unit may then require, in addition to the first months' rent:

- an amount equal to **one-half month's rent**, in addition to the maximum security deposit; and
- a **reasonable fee** to cover administrative costs of processing the waterbed arrangements. [CC §1940.5(g)]

Also, if the term of a residential lease is six months or more, the landlord and tenant may then agree to an advance payment of six months' rent, or more, instead of one month's rent. [CC §1950.5(c)]

Thus, advance payment of an amount equal to only two to five months' rent is prohibited.

Figure 1

***first tuesday** Form 567-1 -*
Notice of Right to Request a Joint Pre-Expiration Inspection

NOTICE OF RIGHT TO REQUEST
A JOINT PRE-EXPIRATION INSPECTION

Prepared by: Agent ____________ **Phone** ____________
Broker ____________ **Email** ____________

NOTE: Residential tenants may request a joint pre-expiration inspection of the premises they occupy. At the inspection they will receive a statement of deficiencies itemizing the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit. [Calif. Civil Code §1950.5(f)]

Scan this QR-Code for a PDF of the Form!

DATE: ____________, 20______, at ________________________, California.
To Tenant: ________________________
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement
- 1.1 dated ____________, at ________________________, California,
- 1.2 entered into by ________________________, as the Tenant, and
- 1.3 ________________________ , as the Landlord,
- 1.4 regarding real estate referred to as ________________________,
- 1.5 which tenancy expires ____________, 20______.

NOTICE:

2. You are hereby advised of your right to request and be present at a pre-expiration inspection of the premises you occupy, and at the time of the inspection, be given Landlord's itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deduction from your security deposit.
- 2.1 The purpose for the inspection and the statement of deficiencies is to give you the opportunity to remedy or eliminate the itemized deficiencies before vacating to avoid a deduction of their cost from your security deposit.
- 2.2 The inspection, if requested by you, may be scheduled no earlier than two weeks before the expiration of your tenancy, and is separate from Landlord's final inspection and accounting for your security deposit within 21 days after you vacate.
- 2.3 If you do not request a pre-expiration inspection, no inspection will be made prior to the final inspection after you vacate.

3. You may request an inspection at any time after you are given this notice by preparing the form attached to this notice and giving it to Landlord or his agent.
- 3.1 On Landlord's receipt of your request, Landlord will attempt to set a mutually agreeable date and time for the inspection.
- 3.2 On Landlord's receipt of your request, you will be given a written 48-hour notice of entry advising you of the date and time scheduled by Landlord for the inspection.

4. On completion of the scheduled inspection, whether or not you are present, Landlord or his agent will hand you or leave on the premises a copy of an itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deductions from your security deposit, unless you remedy or eliminate them prior to your vacating on or before your tenancy expires.
- 4.1 Once you have requested an inspection you may withdraw the request at any time prior to the inspection.

Date: ____________, 20______
Landlord/Agent: ________________ DRE #: ____________
Signature: ________________________
Address: ________________________
____
Phone: ________________ Cell: ____________
Fax: ________________________
Email: ________________________

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PAGE TWO OF TWO — FORM 567-1

REQUEST FOR JOINT PRE-EXPIRATION INSPECTION

Prepared by: Agent ____________ **Phone** ____________
Broker ____________ **Email** ____________

DATE: ____________, 20______, at ________________________, California.
To Landlord:

1. I, the Tenant, hereby request an inspection at the earliest possible date and time during the two-week period prior to the expiration or termination of my tenancy.

2. The dates I prefer for an inspection during normal business hours include ________________________
____

3. I understand you will give me a 48-hour notice prior to the inspection.
Address of the premises ________________________
Tenant's name ________________________

Signature ________________________
Daytime telephone number ____________

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Should the landlord and tenant agree to an advance payment of six months' rent on the lease of an unfurnished unit, the landlord may also require the maximum security deposit of two months' rent.

Landlord treatment of security deposits

Security deposits are held by the landlord as **impounds**. The funds belong to the tenant who advanced them and must be accounted for. [CC §§1950.5(d); 1950.7(b)]

However, while the security deposit belongs to the tenant, a landlord may **commingle** the funds with other monies in a general business account. No trust relationship is established when a landlord holds a tenant's security deposit. [**Korens** v. **R.W. Zukin Corporation** (1989) 212 CA3d 1054]

Without a trust relationship, the landlord's receipt of a security deposit does not obligate him to pay **interest** on the security deposit for the period held. However, some local rent control ordinances require residential landlords to pay interest to tenants on their security deposits.

Joint pre-expiration inspection

A residential landlord must **notify a tenant** in writing of the tenant's **right to request** a joint inspection of his unit to be held during the two weeks prior to the date for expiration of:

- the lease term; or
- a 30-day notice to vacate initiated by either the landlord or the tenant. [CC §1950.5(f)(1); see Figure 1, **first tuesday** Form 567-1]

The requirement of notice does not apply to tenants who are unlawfully remaining in possession after the expiration of a 3-day notice to pay/perform or quit for failing to pay rent, failing to perform terms and conditions of the rental agreement or committing waste or a nuisance on the property.

The purpose for the *joint pre-expiration inspection*, legally called an *initial inspection*, is to require residential landlords to advise tenants of the repairs or conditions the tenant needs to perform or maintain to **avoid deductions** from the security deposit.

If a residential tenant requests the pre-expiration inspection in response to the notice of his right to the inspection, the landlord or his agent must complete the inspection no earlier than two weeks before the tenant is to vacate the unit.

Ideally, the notice advising the tenant of his right to a joint pre-termination inspection is given to the tenant at least 30 days prior to the end of the lease term or, in the case of a rental agreement, immediately upon receiving or serving a 30-day notice to vacate.

A period of 30 days will allow the tenant time to request the inspection and provide two full weeks to prepare for the inspection. The tenant will have two weeks to remedy any repairs or

Figure 2

first tuesday Form 567-3 - Statement of Deficiencies on Joint Pre-Expiration Inspection

Scan this QR-Code for a PDF of the Form!

STATEMENT OF DEFICIENCIES
ON JOINT PRE-EXPIRATION INSPECTION

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

DATE: __________, 20____, at ______________________________, California.

To Tenant: ____

Items left blank or unchecked are not applicable.

FACTS:

1. On this date, a pre-expiration inspection was conducted by Landlord on the premises and appurtenances which are the subject of a rental or lease agreement

1.1 dated ______________, at ______________________________, California,

1.2 entered into by______________________________, as the Tenant(s), and ______________________________, as the Landlord,

1.3 regarding real estate referred to as ______________________________ ______________________________.

1.4 ☐ Tenant was present and given a copy of this statement prepared and signed by Landlord or his agent.

1.5 ☐ Tenant was not present and a copy of this statement prepared and signed by Landlord or his agent was left inside the premises.

2. The tenancy under the rental or lease agreement expires on __________, 20____, by which date you are to vacate the premises.

3. NOTICE TO TENANT:

3.1 You have until the date for expiration of your tenancy to remedy or eliminate the repairs and cleaning specified in this Statement of Deficiencies to avoid the deduction from your security deposit of the cost to repair and clean the identified deficiencies.

3.2 Unobservable conditions or conditions which occur after the pre-expiration inspection requiring repair and cleaning will be deducted from your security deposit after the final inspection by Landlord or his agent.

STATEMENT OF DEFICIENCIES:

4. The following itemized list of identified deficiencies in repairs and cleaning will be the basis for deductions from your security deposit, unless remedied or eliminated by you prior to vacating and later confirmed by Landlord or his agent during a final inspection after you vacate.

4.1 Damage to the premises and appurtenances caused by Tenant or their guests, other than ordinary wear and tear, which needs to be repaired are listed as follows: ______________________________
____
____
____
____
____
______________________________.

4.2 Cleaning which needs to be performed to bring the premises up to the level of cleanliness which existed on commencement of the tenancy is listed as follows: ______________________________
____
____
____
____
____
______________________________.

— — — — PAGE ONE OF TWO — FORM 567-3 — — — —

— — — — PAGE TWO OF TWO — FORM 567-3 — — — —

5. The following recitals are excerpts from Civil Code §1950.5 regarding security deposits:

5.1 1950.5(b) As used in this section, "security" means any payment, fee, deposit or charge, including, but not limited to, any payment, fee, deposit, or charge, except as provided in Section 1950.6, that is imposed at the beginning of the tenancy to be used to reimburse the landlord for costs associated with processing a new tenant or that is imposed as an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:

(1) The compensation of a landlord for a tenant's default in the payment of rent.

(2) The repair of damages of the premises, exclusive of ordinary wear and tear, caused by the tenant or by a guest or licensee of the tenant.

(3) The cleaning of the premises upon termination of the tenancy necessary to return the unit to the same level of cleanliness it was in at the inception of the tenancy. The amendments to this paragraph enacted by the act adding this sentence shall apply only to tenancies for which the tenant's right to occupy begins after January 1, 2003.

(4) To remedy future defaults by the tenant in any obligation under the rental agreement to restore, replace, or return personal property or appurtenances, exclusive of ordinary wear and tear, if the security deposit is authorized to be applied thereto by the rental agreement.

5.2 1950.5(d) Any security shall be held by the landlord for the tenant who is party to the lease or agreement. The claim of a tenant to the security shall be prior to the claim of any creditor of the landlord.

Date: __________, 20____

Landlord/Agent: ____________________ DRE #: __________

Signature: ______________________________

Address: ______________________________

____

Phone: ____________________ Cell: ____________________

Email: ______________________________

FORM 567-3 03-11

uncleanliness the landlord observes during the inspection which might constitute a deduction from the security deposit.

On the landlord's receipt of the tenant's request for a pre-termination inspection, the landlord must serve a written 48-hour **notice of entry** on the tenant stating:

- the purpose of entry; and
- date and time of the pre-expiration inspection.

On completion of the pre-expiration inspection, the landlord must give the tenant an itemized statement of deficiencies specifying any repairs or cleaning necessary to be completed by the tenant to avoid deductions from his security deposit. [See Figure 2, **first tuesday** Form 567-3]

The landlord's *pre-expiration inspection statement* must be delivered to the tenant by either:

- handing the statement directly to the tenant if he is present at the inspection; or
- leaving the statement inside the premises at the time of the inspection if the tenant is not present. [CC §1950.5(f)(2)]

Alternatively, unless requested by the tenant, the landlord or his agent are not required to conduct an inspection or prepare and give the tenant a statement of deficiencies before the tenancy expires and the tenant vacates. However, the notice of the tenant's right to request a pre-expiration inspection must be given to the tenant.

Editor's note — The completion of a pre-expiration inspection statement by the landlord does not bar the landlord from deducting other costs from the security deposit for:

- *any damages noted in the joint pre-expiration inspection statement which are not cured;*
- *any damages which occurred between the pre-expiration inspection and termination of the tenancy; or*
- *any damages not identified during the pre-expiration inspection due to the tenant's possessions being in the way. [CC §1950.5(f)]*

Regardless of whether the tenant requests a pre-expiration inspection, the final inspection and the itemized statement for the refund of the security deposit (less any deductions) must still be completed and mailed within 21 days after the **tenant vacates** the residential unit. [CC §1950.5(g)]

Residential deposit refund requirements

Within a window period of **21 days** after a residential tenant vacates, the residential landlord must:

- refund the security deposit, less reasonable deductions; and

- provide the tenant with an **itemized statement of deductions** taken from the security deposit. [CC §1950.5(g); see Form 585 accompanying this chapter]

Also, the residential landlord must **attach copies** of receipts, invoices and/or bills to the itemized statement showing charges incurred by the landlord and deducted from the security deposit. [CC §1950.5(g)(2)]

If repairs by the landlord are not completed and the costs are unknown within 21 days after the tenant vacates, the landlord may deduct a **good faith estimated amount** of the cost of repairs from the tenant's security deposit. This estimate is stated on the itemized security deposit refund statement, disclosing the name, address and telephone number of any person or entity providing repair work, materials or supplies for the incomplete repairs. [CC §1950.5(g)(3)]

Within 14 days after the **completion of repairs** or the receipt of bills, invoices and/or receipts for the repairs and materials, the landlord must deliver the final itemized security deposit refund statement with attached receipts and invoices to the tenant. [CC §1954(g)(3)]

It is not necessary for the landlord to provide copies of receipts, bills and/or invoices for repair work or cleaning to the tenant if:

- the total deduction from the security deposit to cover the costs of repairs and cleaning does not exceed $125; or
- the tenant signs a waiver of his right to receive bills at the time or after notice to terminate his tenancy is given. [CC §1950.5(g)(4)]

A residential tenant may request copies of receipts, bills or invoices for repair work or cleaning within 14 days after receipt of the itemized security deposit refund statement. The landlord is to provide copies of the documents within 14 days after receipt of the tenant's request. [CC §1950.5(g)(5)]

Reasonable deductions from a residential tenant's security deposit include:

- **delinquent rent**;
- **costs to clean** the premises after the tenant vacates — if the tenant agreed to and failed to leave the unit in the same level of cleanliness as existed when he took occupancy;
- **costs of repairs** for damages caused by the tenant, excluding ordinary wear and tear; and
- **costs to replace or restore** furnishings provided by the landlord if agreed to in the lease. [CC §1950.5(b)]

Unpaid late charges and bounced check charges incurred and requested on a proper demand may be deducted from the security deposit since they are a **form of rent** in that they are **amounts due** the landlord under the lease agreement.

The landlord may not deduct from a tenant's security deposit the costs he incurs to repair defects in the premises which existed prior to the tenant's occupancy. [CC §1950.5(e)]

SECURITY DEPOSIT DISPOSITION ON VACATING RESIDENTIAL PREMISES

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: This itemized statement of the security deposit's disposition, including documentation of charges deducted, must be given to the Tenants by the Landlord within 21 days after a Tenant vacates residential property. [California Civil Code §1950.5(f)]

Use of this form in a timely and proper fashion avoids Landlord liability for a 2% monthly penalty on any portion of the security deposit wrongfully retained.

DATE: ____________, 20_____, at ______________________________, California.
To Tenant: ______________________________

Items left blank or unchecked are not applicable.

FACTS:

1. This is notice to Tenant of any Landlord deductions from the security deposit under the following agreement:
☐ Residential lease agreement ☐ Occupancy agreement
☐ Residential rental agreement ☐ ____________________

1.1 dated ____________, 20_____, at ______________________________, California,
1.2 entered into by ______________________________, as the Landlord, and
1.3 ______________________________, as the Tenant,
1.4 regarding residential premises referred to as ______________________________.

DISPOSITION OF DEPOSIT:

2. Under the above referenced agreement, Tenant handed Landlord a security deposit in the amount of . . . . $____________

3. The following deductions have been made by Landlord from the security deposit:
3.1 Repair of damages — Cost
a. ______________________________ $____________
b. ______________________________ $____________
3.2 Necessary cleaning of the premises — Cost
a. ______________________________ $____________
b. ______________________________ $____________
3.3 Delinquent or holdover rent — Amount
a. From ____________ To ____________ $____________
3.4 Replacement/repair of lost or damaged furnishings — Cost
a. ______________________________ $____________
3.5 **TOTAL** deductions from security deposit (line 3.1 to line 3.4) . . . . (-)$____________

4. BALANCE DUE TENANT:
4.1 Balance of security deposit remaining after deductions (line 2 less line 3.5) $0.00
4.2 Interest on the security deposit from ____________ to ____________
at _____% per annum . . . . (+)$____________
4.3 Balance due Tenant is refunded in the amount of (line 4.1 plus line 4.2) $0.00
by Landlord/Agent's check #____________.

5. ☐ **AMOUNT DUE LANDLORD:**
5.1 The amount due Landlord after deductions (line 2 less line 3.5). . . . . $____________
5.2 Less interest on the security deposit from ____________ to ____________
at _____% per annum . . . . (-)$____________
5.3 Tenant to hand or mail Landlord/Agent the balance due of (line 5.1 less line 5.2) . . . . $____________

This statement is true and correct.
Date: ____________, 20_____
Landlord/Agent: ____________________ DRE #: __________

Signature: ______________________________
Address: ______________________________
____
Phone: ____________________ Cell: ____________________
Email: ______________________________

FORM 585 03-11

Scan this QR-Code for a PDF of the Form!

Tenants seeking to recover security deposits retained by landlords may make unfounded claims that the excessive wear and tear existed when they took possession of the property. To best avoid claims of pre-existing defects, a joint inspection of the unit (landlord and tenant) and written documentation of any defects is completed **before possession** is given to the tenant. [See **first tuesday** Form 560]

Security deposit refund statements

When a residential tenant vacates, the landlord itemizes the deductions from the tenant's security deposit on a security deposit disposition statement. [See Form 585]

A residential landlord who, in bad faith, fails to comply with security deposit refund requirements may be subject to statutory penalties of up to twice the amount of the security deposit. [CC §1950.5(*l*)]

A residential or nonresidential landlord also delivers an itemized statement to tenants on the **sale of the property**, indicating the amount of the security deposits, any deductions and the name, address and telephone number of the buyer. The notice, important for the seller, **shifts liability** for the future return of the security deposit to the buyer. [CC §§1950.5(h); 1950.7(d); see **first tuesday** Form 586]

Nonresidential deposit refund rules

A nonresidential lease does not need to set forth:

- the circumstance under which a tenant's security deposit will be refunded; or
- a time period within which a landlord will refund a tenant's security deposit.

Other than its receipt, a nonresidential lease does not even need to contain a provision addressing when the security deposit will be returned. [See **first tuesday** Form 552]

A nonresidential landlord must return the remainder of the security deposit within **30 days** if:

- a refund period is not agreed to; and
- the nonresidential landlord takes no deductions from the security deposit.

30 days is considered a reasonable refund period since the landlord is allotted 30 days to determine whether repairs are needed. Permissible deductions from the security deposit include unpaid rent, cost of cleaning or repairs.

However, if the security deposit **exceeds** two months rent and the only deduction from the deposit is for delinquent rent, the nonresidential landlord must return any remaining amount in excess of one month's rent within two weeks after taking possession of the property. The remaining security deposit amounts must be returned to the tenant or accounted for within 30 days after the landlord takes possession. [CC §1950.7(c)]

Unless otherwise stated in the lease or rental agreement, the nonresidential landlord is prohibited from deducting additional costs from the security deposit for "key money" or

to cover his attorney's fees incurred in preparing, altering or renewing the lease or rental agreement. [CC §1950.8(b)]

Unlike the residential landlord, the nonresidential landlord is not required to provide tenants with an itemized statement of deductions when the security deposit is refunded.

However, a prudent nonresidential landlord provides tenants with an itemized statement when they vacate, unless a full refund is made.

An accounting avoids the inevitable demand for documentation which arises when a tenant does not receive a full refund of his security deposit.

A nonresidential landlord who, in bad faith, fails to comply with the refund requirements is liable to the tenant for up to $200 in statutory damages. [CC §1950.7(f)]

Chapter 80 — Residential turnover cost recovery

This chapter demonstrates how rent is a residential landlord's sole source of funds to pay for his normal tenant wear-and-tear turnover costs.

For a further discussion of this topic, see Chapter 20 of Real Estate Property Management.

Chapter 80 Outline

The security deposit plays no role
Classifying the receipt of tenant funds
Security deposit deductions for defaults
Covering tenant turnover costs
The lease reduces costs

Chapter 80 Terms

Net operating income	*Security deposit*
Out-of-pocket cost	*Spendable income*

The security deposit plays no role

The landlord of an apartment complex, following a cost-reduction review of management operations, determines he must reduce or offset the costs of tenant turnover by shifting the costs to tenants.

An increasing number of his tenants are staying for ever shorter periods of time. On vacating, the units are re-renting quickly, keeping lost rent due to "turn-around" at a minimum. However, he cannot safely raise rents to cover the costs without losing tenants to competing units.

Each tenant turnover requires expenditures to:

- refurbish the unit to eliminate the cumulative effect of normal wear and tear brought about by the tenant's use of the unit, such as painting the walls, deep-cleaning the carpet and dry-cleaning the drapery;
- advertise the unit's availability to locate a tenant; and
- pay leasing fees and the property manager.

Since the rate of tenant turnovers is exceeding prior expectations, the landlord's *net operating income* (NOI) is being reduced by the increased frequency of furbishing and reletting costs.

From the landlord's point of view, the NOI is calculated by subtracting operating costs from rental income generated by the property.

The landlord is concerned about the economic impact of his costs on ownership since the *value* of the property for establishing its net worth (equity), maximum loan available and sales price is based on the NOI.

Also, his *spendable income* remaining after loan payments has slipped due to increasing turnover costs.

To increase the property's NOI and net spendable income, the landlord chooses to add a *stay-or-pay* clause to his month-to-month rental agreements.

The *stay-or-pay clause* calls for the residential tenant to forego a return of his security deposit if he moves within six months after taking occupancy.

The landlord believes the stay-or-pay clause will dissuade month-to-month tenants from moving for at least six months.

If a tenant is unpersuaded and vacates the premises within the first six months, the stay-or-pay clause states the landlord can recover his "prematurely incurred" turnover costs from the tenant's security deposit.

Can the landlord enforce the stay-or-pay clause in his rental agreements claiming they are based on sound economic principles?

No! The stay-or-pay clause is unenforceable. It is an illegal forfeiture of the security deposit.

The security deposit must be fully refunded regardless of how long the unit remains vacant, if:

- the tenant has not breached the rental or lease agreement; and
- on expiration of proper notice, returns the unit in the condition it was received, less wear and tear

The security deposit **may not** be used to cover either:

- rent lost for the period of the vacancy; or
- costs incurred to eliminate normal wear and tear and refurbish the unit for the next tenant. [Calif. Civil Code §1950.5(e)]

Classifying the receipt of tenant funds

Funds received from a tenant by a **residential landlord** fall into one of only four classifications of receipts:

- tenant screening fees;
- waterbed administration fees;
- rent; and
- security deposits.

Further, the tenant screening fee is limited to:

- the **out-of-pocket cost** (money) for gathering the information; and
- the cost of the landlord's or property manager's time spent obtaining the information and processing an application to rent. [CC §1950.6(b)]

It is common practice for landlords and property managers to request a copy of the tenant's credit report, which the tenant can obtain online from landlord-tenant screening services for far less than the maximum screening fee.

Rent is compensation, usually periodic, received as revenue by a landlord in exchange for the tenant's use, possession and enjoyment of the property. [**Telegraph Ave. Corporation** v. **Raentsch** (1928) 205 C 93]

Rent also includes amounts due from a tenant in payment of any late charges agreed to and demanded on the delinquent payment of periodic rent.

Rent also includes bank charges for bounced checks. [**Canal-Randolph Anaheim, Inc.** v. **Moore** (1978) 78 CA3d 477]

A charge for any purpose other than rent, a tenant screening fee or a waterbed administration fee is, by elimination, a refundable security deposit, regardless of any other name or form given to the funds received. [**Granberry** v. **Islay Investments** (1984) 161 CA3d 382]

A **security deposit** is any advance payment designed to be used as security for the tenant's future performance of his obligations agreed to in a rental agreement or lease.

Security deposit deductions for defaults

When one month's rent (the first month's rent) is collected in advance from a residential tenant, the **security deposit is limited** to an amount equal to:

- two months' rent for an **unfurnished unit**; or
- three months' rent for a **furnished unit**. [CC §1950.5(c)]

A residential landlord may deduct from the security deposit those amounts reasonably necessary to:

- cure tenant defaults in the payment of rent;
- repair damages to the premises caused by the tenant;
- clean the premises except for normal wear and tear; and
- dispose of abandoned personal property. [CC §1950.5(b)]

Any amount of security deposit remaining after taking allowable deductions must be refunded to the residential tenant within 21 days (three weeks) after the tenant moves out. [CC §1950.5(g)(1)]

A residential landlord's retention of any portion of a security deposit in violation of the deduction rules subjects the landlord to statutory penalties of up to twice the amount of the security deposit, in addition to actual money losses the tenant incurs for the wrongful retention. [CC §1950.5(l)]

Covering tenant turnover costs

Recovery of a landlord's turnover costs must come from the rents received from his tenants — an expense of operations deducted from income. The costs of refurbishing a unit to eliminate normal wear and tear so it can be re-rented in a "fresh" condition are known, or readily available on inquiry, in advance. Financially, the amount of the refurbishing costs must be amortized over the length of each tenant's probable occupancy period so the costs will be recovered as a component of the periodic rent charged to a tenant.

However, since the local rental marketplace determines rent ceilings, a landlord is limited in the amount he can charge for rent and successfully compete for tenants.

Thus, a landlord's most logical cost recovery approach is to contract with tenants to stretch out each tenant's term of occupancy to an optimal minimum length of time to reduce the frequency of tenant turnover and increase net spendable income.

The lease reduces costs

The landlord's best method for recovering turnover costs is to rent to creditworthy tenants on a lease agreement with a one year term or longer, the local rental market permitting. Lower rent may result in longer periods of occupancy. A lease agreement allows the landlord to amortize the anticipated costs of refurbishing the unit over the term negotiated. Also, a lease agreement reduces the frequency of move- outs and provides a schedule for turnover maintenance since tenants under a lease agreement tend to remain in possession until the lease term expires.

Although the market limits the amount a landlord can charge for rent, different rental rates exist for rental and lease agreements in most local markets. Month-to-month tenancies typically give the landlord less time over which he can amortize his turnover costs. A landlord with month-to-month tenants must also deal with the likelihood of frequent turnovers requiring the investment of his time and effort to constantly refurbish and re-rent vacant units.

As compensation, a landlord is able to charge higher rents for month-to-month tenancies which reflects the cost-push of higher and more frequent turnover expenses per unit than occur under a lease.

In contrast, a lease agreement locks a tenant into a fixed period of occupancy, such as one year or longer. Lease agreements reduce the tenant turnover rate, and in turn, reduce operating costs and lost rent due to vacancies. Thus, the landlord can amortize his anticipated turnover costs over a greater period of time.

As a result, the lower rent usually received on lease agreements is a reflection of lower overall refurbishing expenses, reduced annual vacancy rates, less management time and effort, and usually less risk of lost rents.

Chapter 81 — Changing terms on a month-to-month tenancy

This chapter reviews the requirements for a landlord's 30-day notice to alter the terms in a tenant's month-to-month rental agreement.

For a further discussion of this topic, see Chapter 22 of Real Estate Property Management.

Chapter 81 Outline

Landlord's notice to tenant
30-day notice to increase rents
Tenant responses to a change
Rent control restrictions

Chapter 81 Terms

30-day Notice of Change inTerms	*Month-to-month rental agreement*
Covenants and conditions	*Rent control*

Landlord's notice to tenant

All covenants and conditions in a residential or nonresidential month-to-month rental agreement, also called *provisions, clauses, terms, conditions, addenda, etc.*, may be changed on 30 days' written notice by the landlord. [Calif. Civil Code §827]

For example, a residential or nonresidential landlord under a month-to-month rental agreement can increase the rent or shift repair and maintenance obligations to the tenant by serving a 30-day Notice of Change in Rental Terms. [See Form 570 accompanying this chapter]

To be enforceable, the 30-day notice must be served in the same manner as a 3-day notice to pay rent or quit. However, only the landlord may unilaterally change the terms in a rental agreement. [CC §827]

A month-to-month tenant has no ability to alter the terms of his rental agreement, other than to terminate the tenancy and vacate. [CC §1946]

In rent control communities, a landlord or property manager must be fully apprised of how rent control ordinances affect their ability to alter provisions in leases and rental agreements.

30-day notice to increase rents

A landlord or property manager may serve a notice of change in rental terms under a periodic (month-to-month) rental agreement on **any day** during the rental period.

30-DAY NOTICE OF CHANGE IN RENTAL TERMS

Prepared by: Agent ______________________________ **Phone** ________________________
Broker ______________________________ **Email** ________________________

NOTE: To change any terms in a month-to-month tenancy, a Landlord must furnish the Tenant with a written 30-day notice of the change. If rent is raised more than 10% within a 12-month period on a residential Tenant, a 60-day notice of the increase is required. [Calif. Civil Code §827; see **ft** Form 574]

DATE:_____________, 20______, at ____, California.
To Tenant: ____
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental agreement or expired lease agreement
1.1 dated __________________, at ____, California,
1.2 entered into by ____, as the Tenant, and
1.3 ____, as the Landlord,
1.4 regarding real estate referred to as ____
____.

NOTICE:
Thirty (30) days after service of this notice on you, the terms of your tenancy on the real estate are hereby changed as indicated below:

2. Rent shall be $_______________ payable ☐ monthly, or ________________________________,
in advance, and due on the ____________________ day of the month.
2.1 Rent to be paid by ☐ personal check ☐ ____.
2.2 Rent may be tendered by ☐ mail, or ☐ personal delivery,
to ____ (Name)
____ (Address)
____ (Phone, Fax, Email)
a. Personal delivery of rent will be accepted during the hours of ______ to ______ on the following days:
____.
2.3 Rent may also be paid by deposit into account number ________________________________,
at ____ (Financial Institution)
____ (Address)

3. The common area maintenance charge shall be $_______________ per month, payable with each payment of rent.

4. Utilities now paid by Landlord to be paid by Tenant as checked:
☐ Gas ☐ Electricity ☐ Sewage and Rubbish ☐ Water ☐ Cable TV

5. ☐ Tenant to maintain and properly care for the lawns, gardens, trees, shrubs and watering system.

6. An additional security deposit of $_______________ is payable with the next rent payment.

7. Smoking is prohibited in the following area(s) ____
____

8. ____
____

9. This notice affects no other terms of your tenancy.

Date:_____________, 20______
Landlord/Agent:______________________________DRE #: ____________

Signature:____
Phone: ________________________Cell: ________________________
Fax: ____
Email:____

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Once a notice of change in rental terms is served on a month-to-month tenant (or other periodic tenancy), the new terms stated in the notice immediately become part of the tenant's rental agreement. [CC §827]

However, the new rental terms stated in the notice do not take effect until expiration of the 30-day notice.

Tenant responses to a change

On being served with a 30-day notice of a change in rental terms, the month-to-month tenant has three options:

- remain in possession and comply with the new rental terms;
- serve the landlord with a 30-day notice of intent to vacate and pay pro rata rent on the next due date for days remaining unpaid during the month through the end of the 30-day period to vacate; or
- remain in possession, refuse to comply with the rental terms and raise defenses, such as retaliatory eviction, in the resulting unlawful detainer (UD) action.

If the change in terms is a rent increase, the tenant is liable for pro rata rent at the new rate for the days after the rent increase becomes effective until the tenant's notice to vacate — payable in advance on the due date for the next scheduled payment of rent, usually the first.

Rent control restrictions

Most rent control ordinances allow a landlord or property manager to increase the rent to:

- obtain a fair return on his investment;
- recover the cost of capital improvements to the property; and
- pass through the cost of servicing the debt on the property.

Thus, without further authority from the rent control board, a landlord may increase rent in one of three ways:

- increase rent by the maximum percentage set by ordinance;
- increase rent by the maximum percentage of the consumer price index (CPI) as set by ordinance; or
- increase rent by the maximum amount previously set by the rent control board.

Landlords of newly constructed units or individual units (single family residences/condos) may establish their own rental rates, within limitations, if they are subject to rent control ordinances established prior to 1995.

Enforcing rents; terminating tenancies

Chapter 82 — Delinquent rent and the 3-day notice

This chapter explains the requirements and consequences for the use of the 3-day notice to pay rent or quit in residential and nonresidential income properties.

For a further discussion of this topic, see Chapter 25 of Real Estate Property Management.

Chapter 82 Outline

Default, notice and cure or vacate
Three days between notice and UD
When is the rent delinquent?
Accurate residential rent demands
Estimated nonresidential rent
Subtenant evictions by the owner

Chapter 82 Terms

Default	*Material breach*
Delinquency	*Minor breach*
Grace period	*Security deposit*
Incurable breach	*Unlawful detainer*

Default, notice and cure or vacate

A tenant *defaults* on his rental or lease agreement by failing to:

- pay rent and any other **amounts due** called for in the rental or lease agreement; or
- perform nonmonetary obligations called for in the rental or lease agreement.

When a tenant does not **timely pay** rent, the landlord may serve the tenant with a written notice demanding the tenant pay all amounts due or vacate the premises within three days, called a *3-day notice to pay rent or quit*.

However, only a *material breach* allows for the landlord to forfeit of the tenancy.

Failure to pay rent or perform other significant obligations called for in the rental or lease agreement is a **material breach**. Conversely, the tenant's failure to pay late charges, interest penalties, bad check charges or security deposits are *minor breaches*, which alone do not justify a demand to cure or quit under a 3-day notice. [**Keating** v. **Preston** (1940) 42 CA2d 110]

A failure to increase the security deposit by paying an additional sum as agreed is not a failure to pay *rent*. Rent must be delinquent before a 3-day notice can be served to collect all other dollar amounts due and unpaid which are minor breaches. A security deposit is *security* for the pay-

ment of rent. A security deposit is not rent. Thus, failure to make a security deposit payment is not a basis for a 3-day notice since it is not rent.

Some nonmonetary defaults by a tenant cannot be cured, such as waste to the premises, alienation of the leasehold or significant criminal activity which has occurred on the property, called *incurable breaches*. The landlord's remedy for an incurable breach is to serve notice on the tenant to quit the premises within three days after service, leaving no alternative but to vacate.

Here, a lease forfeiture clause accompanying the 3-day notice is unnecessary and ineffective since the failure cannot be cured and the tenancy cannot be reinstated. [Calif. Code of Civil Procedure §1161(4)]

Three days between notice and UD

A tenant has three calendar days, day one being the **day after service** of the 3-day notice, in which he may pay the delinquent rental amounts and avoid forfeiture of his possession and eventual eviction. [Calif. Civil Code §10]

The tenant cures the default, retaining his right to possession by paying the amount stated before the 3-day notice expires. [CCP §1161.5]

During the three-day notice period, the tenant may **tender payment** of the rent and cure the default in the same manner the tenant made past rental payments — by personal or company check, money order, cashier's check, cash or electronic transfer. [**Strom** v. **Union Oil Co.** (1948) 88 CA2d 78]

A tenant's rent that is paid by check and received on time by the landlord sometimes becomes delinquent when the check is returned to the landlord due to the tenant's lack of sufficient funds with his bank. Since the rent is delinquent, the landlord can now serve a 3-day notice to pay or quit. However, he cannot now limit his demand for payment to cash or a money order in the 3-day notice since the tenant has been paying rent by check.

A rent check received by the landlord during the 3-day notice period must be paid by the tenant's bank to cure the delinquency. If it is returned for lack of sufficient funds (or otherwise), the delinquent rent has not been paid, the notice has expired and the tenant's right to possession terminated by reason of the declaration of forfeiture.Thus, the landlord may file a UD action if the tenant remains in possession.

Before a landlord or his property manager serves a tenant with a 3-day notice to pay rent or quit, the following questions must be answered:

- Is the rent delinquent?
- What amounts are due and unpaid?
- When can rent earned be estimated in the 3-day notice?
- What is a reasonable estimate of delinquent rent?

- When does the 3-day notice expire?
- When does the tenant's right to possession terminate? and
- How are subtenants evicted?

When is the rent delinquent?

Rent must be **delinquent** before a 3-day notice to pay or quit may be served.

Rent becomes **delinquent**:

- the day following the last calendar day of the **grace period** established in the rental or lease agreement; or
- the day following the due date, when the rental or lease agreement does not provide for a **grace period**.

However, when the last day scheduled for payment of rent falls on a legal holiday, the payment may be **tendered** on the **next business day**. A **legal holiday** is every Saturday, Sunday and any other day designated by the state as a holiday, which includes federal holidays. [CCP §§10; 12a]

Likewise, if the last day of a **grace period** for payment of past due rent (which could be the due date) falls on a Saturday, the tenant's rent payment is not delinquent if it is received by the

The holdover tenant

When a lease contains a holdover provision, the landlord's failure to evict the tenant after serving a three-day notice does not create a month-to-month tenancy with rent due as stated in the holdover provision. [**Walt** v. **Superior Court** (1992) 8 CA4th 1667]

Similarly, a three-day notice is not required once a 30-day notice to vacate served on a tenant has expired since a 30-day notice also establishes an unlawful detainer. [CC §1946]

A holdover occurs when a tenant remains in possession after the agreed lease term expires, not when the three-day notice expires. When a tenant holds over, the landlord may immediately file a UD action without serving any notice. [CCP §1161(1)]

However, a landlord under an expired lease should only seek to recover possession, not rent, in a UD action filed against the holdover tenant.

Then in a separate action, the landlord can recover money losses under the holdover provision for the period of the tenant's unlawful detainer.

Typically, holdover rent exceeds fair rental value and will not be the basis for rent awards in a UD action.

landlord on the first business day following the legal holiday, which would be Monday unless it is designated a federal holiday. [CCP §13; Calif. Government Code §6706]

Thus, when the final day of the 3-day notice falls on a holiday such as a Saturday, Sunday or legal holiday, the 3-day notice expires on the next business day. [**Lamanna** v. **Vognar** (1993) 17 CA4th Supp. 4; CCP §12a]

Unlike the service of documents in civil actions, mailing of the 3-day notice for failure of attempts at personal service does not extend the three-day notice period an additional five days. [**Losornio** v. **Motta** (1998) 67 CA4th 110]

To initiate the **rent collection process** against a tenant who is in possession, the landlord serves the tenant with a 3-day notice to pay rent or quit. The notice may be served on any day after the grace period has expired without receipt of the rent, called a *delinquency*.

A **grace period** is stated in a rental or lease agreement as a set time period following the due date during which rent may be paid without incurring a *late charge*. While rent may be unpaid and past due, it is not **delinquent** until the grace period expires and a late charge may be demanded.

Accurate residential rent demands

To be valid, the 3-day notice to pay rent or quit served on a **residential tenant** must state the **exact amount** of money due which has not been paid. Conversely, **nonresidential rent** may be **estimated** when the exact amount cannot be accurately ascertained.

A residential tenant is not required to pay more than the amount due and unpaid to retain his possessory right under his rental or lease agreement. Likewise for nonresidential tenants, even if the rent they pay is erroneously estimated at a higher amount than the amount due.

However, if the amount stated in a 3-day notice served on a **residential tenant** exceeds the amounts actually due and unpaid at the time of the UD trial, the notice is invalid. [**Jayasinghe** v. **Lee** (1993) 13 CA4th Supp. 33]

For both residential and nonresidential tenants, if the amount stated in the 3-day notice is less than the actual amount due and unpaid, the tenant may pay the amount stated and avoid eviction. To collect any amounts omitted in a 3-day notice, the landlord must serve another 3-day notice to pay the balance or quit.

Estimated nonresidential rent

When the property leased is nonresidential, the 3-day notice may include an *estimate* of the amounts due if:

- the notice states the amount due is an estimate; and
- the amount estimated is reasonable. [CCP §1161.1(a)]

An estimate of rent owed in a 3-day notice is **considered reasonable** if:

- the actual amount owed is truly in question; and
- the delinquent amount demanded is neither 20% **more or less** than the amount determined due at the UD hearing. [CCP §1161.1(e)]

Subtenant evictions by the owner

For an owner to regain possession when the (master) tenant defaults and a subtenant occupies the premises, the 3-day notice must also **name** the subtenant as a tenant in default and be served on the subtenant. [CCP §1161]

Serving a subtenant with a copy of the 3-day notice that only names the master tenant will result in the subtenant retaining his right to possession. [**Briggs** v. **Electronic Memories & Magnetic Corporation** (1975) 53 CA3d 900]

Conversely, an owner who wishes to evict a defaulting master tenant but retain the subtenant may do so. The owner is not required to serve the subtenant with a 3-day notice when only the master tenant is being evicted. [**Chinese Hospital Foundation Fund** v. **Patterson** (1969) 1 CA3d 627]

Chapter 83 Three-day notices to quit

This chapter identifies the proper 3-day notice to serve on a tenant for a material breach of a rental or lease agreement, other than for past due amounts of money.

For a further discussion of this topic, see Chapter 26 of Real Estate Property Management.

Chapter 83 Outline

Types of 3-day notices for various breaches
Notice to perform or quit
Curable nonmonetary breaches
Notice to quit; no alternatives
Quit! The breach cannot be undone
Breach of statutory prohibitions
Forfeiture on assigning or subletting
Waste forfeits the lease

Chapter 83 Terms

Holdover	*Reinstatement period*
Lease forfeiture clause	*Retaliatory eviction*
Material breach	*Sublease*
Nuisance	*Unlawful detainer*
Pay Rent or Quit	*Waste*
Perform or Quit	

Types of 3-day notices for various breaches

The 3-day notice served on a tenant must be the correct type before the tenant's unlawful detainer, or *holdover*, of a premises can be established and the tenant evicted.

Depending on the nature and extent of the tenant's breach, one of the following types of 3-day notices may be served:

- a 3-Day Notice to **Pay Rent or Quit** [See Form 576 accompanying this chapter]**;**
- a 3-Day Notice to **Perform or Quit** [See Form 576]; or
- a 3-Day Notice to **Quit**. [See Form 577 accompanying this chapter]

When a tenant's breach is the **failure to pay** rent or other money obligation which is due, the tenant is served with a 3-day *notice to pay rent or quit*.

When the lease provision breached is not for rent or other money obligation, called a *nonmonetary breach*, and the breach can still be quickly corrected by the tenant, the tenant is served with a 3-day *notice to perform or quit*. [See Form 576]

However, a tenant who is in default on both the payment of money and a curable nonmonetary provision in the lease, such as the obligation to maintain the landscaping, a 3-day notice to perform or quit is used. The demand to pay rent is listed as an additional (monetary) breach to be cured under the notice to perform or quit.

A 3-day *notice to quit* containing no alternative and requiring the tenant to vacate is served on a tenant when the tenant's breach is:

- impossible to cure in three days [**Matthew** v. **Digges** (1920) 45 CA 561]; or
- a statutory breach, such as an unauthorized subletting of the premises, nuisance or unlawful use of the premises. [Calif. Code of Civil Procedure §1161(4); see Form 577]

Notice to perform or quit

The 3-day **notice to perform or quit** requires the tenant to either:

- **perform** under the breached lease provision; or
- **vacate** the premises. [CCP §1161(3)]

The tenant's breach of the rental or lease agreement must be a *significant breach*, called a *material breach*, to justify serving a 3-day notice to perform or quit. A minor or trivial breach by the tenant will not support a 3-day notice. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

In order for the tenant to avoid a forfeiture of his right to occupy the property, he must be given an opportunity to **reinstate** the rental or lease agreement — if the breach can be cured in three days.

The 3-day notice to perform or quit will specify the provision breached and the action required to cure the breach. When the tenant cures the breach before the 3-day notice expires, the rental or lease agreement is **reinstated** and possession continues as though no breach occurred.

To eliminate the tenant's right to also reinstate the rental or lease agreement after the 3-day notice expires, a *reinstatement period* to avoid eviction that runs on the fifth day after the UD trial, the notice must clearly state the landlord's election to terminate the tenant's right to possession if the tenant fails to perform, called a *lease forfeiture clause*. [CCP §1174(a)]

The tenant who vacates instead of performing forfeits his **possessory right** to occupy the leased premises. Further, the tenant cannot reinstate the right to possession after expiration of the 3-day notice to perform or quit when the landlord declares his election to terminate possession by declaring a forfeiture in the notice. [See Form 576 §4]

THREE-DAY NOTICE TO PERFORM OR QUIT

Prepared by: Agent ______________________ Phone ______________
Broker ______________________ Email ______________

NOTE: A tenant who fails to perform any terms of the rental or lease agreement which can be performed or rectified must within three (3) days after service of written notice of the breach, either cure the breach or vacate and deliver possession of the premises to the landlord. [Calif. Code of Civil Procedure §1161(3)]

DATE: ____________, 20____, at ______________________________, California.

To Tenant: ____

Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or expired lease agreement
   1.1 dated ______________, at ______________________________, California,
   1.2 entered into by ______________________________, as the Tenant, and ______________________________, as the Landlord,
   1.3 regarding real estate referred to as ______________________________ ______________________________.

NOTICE:

2. You are in breach of the terms of your rental or lease agreement as follows: ______________________________ ______________________________ ______________________________.
3. Within three (3) days after service of this notice, you are required to either:
   3.1 Perform or rectify the breach by ______________________________ ______________________________ ______________________________,

   OR

   3.2 Deliver possession of the premises to Landlord or ______________________________ ______________________________.
4. If you fail to cure the breach or to deliver possession within three (3) days, legal proceedings may be initiated to regain possession of the premises and to recover the rent owed, treble damages, costs and attorney fees.
5. Landlord hereby elects to declare a forfeiture of your lease if you fail to cure the breach noted above.
   5.1 Landlord reserves the right to pursue collection of any future rental losses allowed by Calif. Civil Code §1951.2.

Date: ____________, 20____

Landlord/Agent: ______________________ DRE #: __________

Signature: ______________________________

Address: ______________________________ ______________________________

Phone: ______________ Cell: ______________

Fax: ______________________________

Email: ______________________________

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In spite of the forfeiture of the right to possession, the lease agreement, including provisions imposing obligations on the tenant to pay money, remains fully enforceable by the landlord after the tenant's leasehold interest is terminated. The lease agreement was not canceled.

The tenant's failure to either cure the breach by performance or vacate within the three days following service of a notice and election to forfeit allows the landlord to initiate a UD action and have the tenant removed without the right to reinstate possession after the 3-day notice expires. [CCP §1161(3)]

Curable nonmonetary breaches

A tenant operates a retail business on leased premises. The lease agreement requires the tenant to periodically provide the landlord with a list of his sales merchandise in inventory. Also, the landlord is permitted to examine the tenant's business records.

Upon the landlord's request, the tenant does not provide the inventories or permit the landlord to examine his business records.

The landlord serves the tenant with a 3-day notice to quit the premises — no alternative performance is given to allow the tenant to rectify the failures and stay. The tenant does not vacate the premises.

The landlord files a UD action, seeking to evict the tenant since he breached a material lease obligation.

The tenant claims he cannot be evicted since the 3-day notice did not give the tenant the alternative to perform under the rent provisions by delivering inventory lists and records to avoid a forfeiture of possession.

Can the landlord maintain a UD action against the tenant based on the 3-day notice to quit?

No! The 3-day notice served on the tenant must be in the alternative — perform or quit — since the tenant could have handed over an inventory to the landlord and given the landlord access to the business records, all within three days. [**Hinman** v. **Wagnon** (1959) 172 CA2d 24]

A landlord must allow a tenant to cure a material breach, monetary or nonmonetary, within three days after notice when the tenant is capable of performing under the breached lease provision within three days. [CCP §1161(3)]

Notice to quit; no alternatives

If the lease provision violated by the tenant calls for or prohibits an activity that constitutes a material breach and cannot be performed or rectified within three days, the tenant may be served with a 3-day notice to quit. No alternative activity need be stated in the notice as nothing can or remains to be done which the tenant can do (or stop doing) within three days. [CCP §1161(3); see Form 577]

For example, possession can be recovered by service and expiration of a 3-day notice to quit based on *statutory forfeitures* when a tenant:

THREE-DAY NOTICE TO QUIT

Residential and Nonresidential

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: A tenant must vacate and deliver possession to the landlord within three (3) days after service of written notice for breach of any terms of the rental or lease agreement which cannot be performed or rectified. [Calif. Code of Civil Procedure §1161(4)]

DATE:__________, 20_____, at ______________________________, California.

To Tenant: ______________________________

Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental agreement or expired lease agreement

1.1 dated ______________, at ______________________________, California,

1.2 entered into by ______________________________, as the Tenant,
and ______________________________, as the Landlord,

1.3 regarding real estate referred to as ______________________________
______________________________.

NOTICE:

2. You are in breach of the terms of your rental or lease agreement as follows:
____
____
____
____
____
____
____

3. Within three (3) days after service of this notice, you are required to vacate and deliver possession of the premises to Landlord or ______________________________.

4. If you fail to vacate and deliver possession of the premises within three (3) days, legal proceedings may be initiated to regain possession of the premises and to recover the rent owed, treble damages, costs, and attorney fees.

5. Landlord hereby elects to declare a forfeiture of your lease.

5.1 Landlord reserves the right to pursue collection of any future rental losses allowed by Calif. Civil Code §1951.2.

Date: __________, 20_____

Landlord/Agent: ____________________DRE #:__________

Signature: ______________________________

Address: ______________________________
____

Phone:____________________Cell: ____________________

Fax: ______________________________

Email:______________________________

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- maintains a *nuisance* on the premises;
- uses the premises for an *unlawful purpose*; or
- *assigns, sublets* or *commits waste* to the premises in breach of a lease provision. [CCP §1161(4)]

The 3-day notice to quit does not need to indicate the provision breached or the activity of the tenant constituting the breach, such as an unlawful use, nor does it need to include a lease forfeiture declaration by the landlord. The right to possession — the lease — is **automatically forfeited** by the breach, not by the running of the 3-day notice. The tenant's right to possession may not be reinstated unless the landlord chooses to waive the forfeiture.

The landlord serves a 3-day notice to quit only because the notice is a requisite to the recovery of possession in a UD action, as a forfeiture of the lease has already occurred by statute due to these enumerated events. [CCP §1161(4)]

Quit! The breach cannot be undone

Consider a tenant who leases agricultural property. The lease agreement states the tenant's use of the property is limited to grazing sheep. However, the tenant plants a crop on the property, a breach of the use provision in the lease agreement.

Based on the tenant's **unauthorized use** of the premises, the landlord initiates the eviction process by serving a 3-day notice to quit on the tenant.

The tenant's use of the property to raise a crop, instead of the single agreed-to use as a pasture, is an *incurable nonmonetary breach* of the lease agreement. The tenant cannot reverse the effects of raising the crop on the soil since the activity has already occurred. [**Harris** v. **Bissell** (1921) 54 CA 307]

Breach of statutory prohibitions

A tenant may be evicted for maintaining a **nuisance** or **unlawful use** of the premises, even if these activities are not prohibited by the lease agreement. [CCP §1161(4)]

A **nuisance** includes anything which:

- is **injurious to health**, such as contamination of the property's soil;
- is **offensive to the senses**, such as excessive noise levels or obnoxious fumes; or
- **obstructs the use and enjoyment** of surrounding property. [Calif. Civil Code §3479]

A tenant who illegally sells, grows or manufactures controlled substances on the premises, has by his actions, triggered an automatic forfeiture of the leasehold. The tenant may be served with a notice to quit for **maintaining a nuisance**, and if he does not vacate, be evicted by a UD action. [CCP §1161(4)]

A tenant's **unlawful use** of the premises under the statute includes violations of local laws or ordinances affecting the property, such as noncompliance with zoning ordinances restricting the

use of the premises. Again, the leasehold is forfeited automatically due to the violation. The 3-day notice is required only as a requisite to a UD action should the tenant remain in possession. [**Haig** v. **Hogan** (1947) 82 CA2d 876]

However, before the unlawful use **justifies** service of a notice to quit, the use must:

- threaten the physical safety of the property;
- stigmatize the premises; or
- impair the landlord's continued receipt of rent.

Forfeiture on assigning or subletting

Consider a lease provision prohibiting the tenant from *assigning* the lease or *subleasing* the premises without first obtaining the landlord's written consent. Unknown to the landlord or his property manager, the tenant subleases the premises. The property manager discovers the premises is occupied by a subtenant.

The property manager names and serves both the **tenant and subtenant** with a 3-day notice to quit. The subtenant does not vacate the premises, and a UD action is filed to regain possession from both the tenant and the subtenant.

The tenant claims his leasehold interest cannot be terminated by the 3-day notice to quit since the landlord cannot unreasonably withhold his consent to a sublease of the premises.

Can the landlord serve a 3-day notice to quit on a tenant who subleased without his consent and evict the tenant?

Yes! The landlord can proceed to evict the subtenant based on a 3-day notice to quit. The tenant failed to request the landlord's consent prior to subletting the premises. Thus, the tenant breached the lease agreement, immediately forfeiting his right to possession without the landlord's need to declare the forfeiture.

The tenant cannot avoid the forfeiture of his leasehold due to the subletting by claiming the landlord cannot unreasonably withhold consent when the landlord was not given the opportunity to grant or withhold his consent. [**Thrifty Oil Co.** v. **Batarse** (1985) 174 CA3d 770]

When provisions in a lease agreement prohibit assignment of the lease or subleasing by the tenant without the landlord's consent, and the tenant assigns or subleases without obtaining consent, a 3-day notice to quit may be served on the tenant to recover possession. By statute, the act is an incurable activity that terminates the lease, leaving no alternative to vacating. [CCP §1161(4)]

However, the landlord need not consider the lease terminated when the tenant assigns the lease or sublets the premises or assigns the lease without the landlord's consent. The landlord can waive the statutory forfeiture of possession.

Thus, a 3-day notice to **perform or quit** may be served on the tenant requiring the tenant to remove the subtenant from the premises — within three days — and retain his right to possession. [CCP §1161(3)]

Waste forfeits the lease

Waste to the leased premises by a tenant is a breach that cannot be cured. Thus, the right to possession has been terminated. The tenant must vacate if the landlord serves a 3-day notice to quit. However, *waste* is grounds for eviction only when the **value** of the leased premises is substantially or permanently diminished — **impaired** — due to the tenant's conduct.

Waste occurs when a tenant:

- **intentionally damages** or destroys the leased premises; or
- neglects the premises and **impairs its value** by failing to care for and maintain it as agreed.

Service of notice

Statutory requirements must be strictly followed when preparing and serving a 3-day notice. [See Chapter 83]

If the 3-day notice is incorrectly or inaccurately prepared, or improperly served on the tenant, the notice is invalid. To evict the tenant, a new 3-day notice must be correctly prepared and properly served. [**Lamey** v. **Masciotra** (1969) 273 CA2d 709]

A proof of service form must be filled out and signed by the person who serves the 3-day notice. Without a proof of service, a UD action cannot be maintained. [See **first tuesday** Form 580]

However, a *retaliatory eviction* does occur in residential properties when the tenant:

- exercises his right to file a complaint with an appropriate agency regarding the **habitability** of the premises;
- orally complains to the landlord about the **habitability** of the premises;
- files documents to initiate a judicial or arbitration proceeding regarding the **habitability** of the premises;
- **organizes or participates** in a tenant association or an association for tenant's rights; or
- lawfully exercises any rights, such as the refusal to authorize credit reports or personal investigation after vacating the premises. [CC §1942.5]

Here, the tenancy was not terminated in retaliation for complaints about the habitability of the premises or for a legal right exercised by the tenant. Instead, the tenant was being evicted for his delinquency in rent payments — a breach by the tenant of the month-to-month rental agreement. A landlord convicted of a retaliatory eviction is liable for punitive damages up to $2,000 for each act of retaliation. [CC §1942.5]

Chapter 84 — Notices to vacate

This chapter explores the notices to vacate used by landlords and tenants to terminate month-to-month tenancies other than by use of a 3-day notice to quit.

For a further discussion of this topic, see Chapter 29 of Real Estate Property Management.

Chapter 84 Outline

Landlord's intent to evict
Tenant's intent to vacate
Service of the notice to vacate
Periodic tenancies extended/terminated
Rent control limitations on eviction
Good reason to evict exception
The requisite 90-day notice to vacate
OBF adherence to an existing lease

Chapter 84 Terms

Arm's length lease agreement	*Owner-by-foreclosure (OBF)*
Bona fide lease	*Personal service*
Good cause	*Rent control community*
Material breach	*Section 8 housing*
Notice to vacate	

Landlord's intent to evict

A landlord, residential or nonresidential, terminates a month-to-month tenancy by preparing and serving the tenant with a 30-day notice to vacate. However, if a *material breach* exists in the payment of amounts due or performance of provisions in the occupancy agreement, a 3-day notice to quit is used. [See **first tuesday** Forms 571 and 579; see Chapter 81]

A *notice to vacate* form used by a landlord contains:

- the name of the tenant;
- the address of the premises;
- a reference to the rental agreement or expired lease;
- a statement that the unit must be vacant within the applicable number of days (30 or 60) after service of the notice;

- the dollar amount of pro rata rent to be paid when rent is next due;
- a statement regarding the security deposit and its disposition; and
- a statement informing the tenant of his right to request a joint inspection of the premises in order to avoid deductions from his security deposit.

Due to its contents, the landlord's notice to vacate eliminates any confusion as to the amount of pro rata rent to be paid and when the rent is due. [See **first tuesday** Form 571 §3]

Tenant's intent to vacate

A tenant, residential or nonresidential, who intends to vacate and avoid further liability under a month-to-month rental agreement or expired lease must give 30-days advance notice to the landlord of the **tenant's termination** of the tenancy. The notice may be in the form of a letter personally delivered to the landlord or his agent, or sent by certified or registered mail. [Calif. Civil Code §1946]

Some landlords are willing to accept oral notice of the tenant's intent to vacate without reducing the notice to a writing signed by the tenant.

However, both the tenant and the landlord are better served when the landlord hands the tenant a 30-day Notice to Vacate form when entering into a rental agreement or, at worst, when the tenant gives oral notice of his vacating the space. The tenant will then have the correct paperwork to complete and deliver documentation to the landlord or property manager. Use of a form lends certainty to the tenant's understanding of a critical event. [See **first tuesday** Form 572]

A tenant's 30-day notice to vacate acknowledges:

- the tenancy is terminated on expiration of 30 days after service of the notice on the landlord or his manager;
- the tenant's intent to pay pro rata rent;
- the amount of the security deposit and the tenant's right to request a pre-termination inspection and receive an itemized statement of maintenance and cleaning deficiencies for any potential deductions from the security deposit; and
- a security deposit statement and refund based on any deductions for cleaning and repairs on a final review of the premises by the landlord or property manager; and
- the landlord's right to show the premises to a prospective tenant on 24 hour notice.

If a tenant serves the landlord or property manager with a 30-day notice to vacate, but fails to vacate the residence after expiration of the notice, he becomes a holdover tenant unlawfully in possession since the tenancy has been terminated by the tenant's notice. The landlord may

immediately file a UD action to evict the tenant. No further notice to quit is required since the tenancy has already been terminated.

Service of the notice to vacate

A notice to vacate may be served at any time during the month.

However, a **nonresidential landlord** and tenant may limit the right to serve the notice at any time by agreeing in the rental agreement that the 30-day notice to vacate cannot be served during the last six days of the month. This is not true for residential tenancies since service can occur at any time to begin the 30-day period. [CC §1946]

To be effective, the notice to vacate from a **nonresidential tenant or landlord** must be served:

- in the same manner as a 3-day notice (in person, by substitution or post and mail); or
- by certified or registered mail, a method of service not available for 3-day notices to quit. [CC §1946]

Conversely, a **residential landlord or tenant** must serve a notice to vacate by:

- personally delivering the notice to either the landlord or tenant; or
- **leaving a copy** of the notice either at the residence or the tenant's place of business with a person of appropriate age, **posting the notice** in a conspicuous place on the property and mailing, by certified or registered mail, a copy addressed to the tenant in the unit. [CCP §§ 1161a, 1162]

The date of service to a nonresidential tenant is the date the notice is first:

- personally served;
- handed to a person of suitable age and discretion and mailed;
- posted on the leased premises and mailed; or
- mailed by certified or registered mail.

The minimum period within which the tenant must vacate begins to run the day after the date of service, which is day one of the 30- or 60-day period. [CC §10]

If the day for expiration of the notice is a Saturday, Sunday or federal holiday, the tenant is not required to vacate until the next business day. [CCP §12a]

Most notice to vacate forms, when filled out by the property manager, give a **specific date** by which the tenant must vacate, at least 30 days after service of the notice. Thus, the day is not left to chance and, as a practical matter, not set as a weekend day or holiday.

Periodic tenancies extended/terminated

Unlike the extension of a lease, the 30-day rental period under a **month-to-month rental agreement** is *automatically extended* for the same period and on the same terms, until the right to extend is terminated by a 30-day notice to vacate.

However, if the property is residential and the tenant has resided on it for one year or more, then the landlord, not the tenant, is required to give the residential tenant a 60-day notice to vacate. [CC §1946; see **first tuesday** Form 569-1]

Any landlord under a month-to-month rental agreement (or for any other period) may **interfere at any time** with the automatic renewal of the rental agreement and terminate the tenancy by serving a 30-day notice to vacate on the tenant.

Likewise, any tenant under a month-to-month rental agreement may, at any time, stop the automatic renewal process and terminate the tenancy by giving the landlord a 30-day notice of the tenant's intent to vacate the premises. [CC §1946.1; see **first tuesday** Form 572]

A notice to vacate on a month-to-month tenancy, whether given by the tenant or the landlord, establishes a tenant's unlawful detainer (UD) when it expires and the tenant remains in possession. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp. 859]

Once the notice to vacate expires and the tenant does not vacate, the landlord may file a UD action to evict the month-to-month tenant without further notice. [Code of Civil Procedure §1161(5)]

Rent control limitations on eviction

When a residential rental property is located in a *rent control community*, the landlord is limited in his discretionary ability to terminate the tenancy and evict the tenant on a notice to vacate.

Typically, the termination of a tenancy and evictions are allowed in rent control communities when:

- the tenant fails to pay rent or otherwise materially breaches the lease agreement;
- the tenant creates a nuisance;
- the tenant refuses to renew a lease;
- the tenant uses the residence for an illegal purpose; or
- the landlord or a relative will occupy the unit.

A landlord and property manager for properties subject to rent control and his property manager must make themselves aware of the local restrictions imposed on the eviction of tenants.

Good reason to evict exception

A landlord is not required to state his reasons in a notice to vacate, or even have *good cause*, for evicting a month-to-month tenant. [CC §1946]

Rent control and *Section 8 housing* are exceptions to the general rule that do not require **good cause**. The exceptions require the giving of a good-cause condition as the reason for terminating these tenancies. Thus, the tenant is given notice so he can prepare his defense to avoid eviction.

However, under no condition may a landlord evict a tenant for the wrong reason.

The landlord terminating a tenancy for the wrong reason may find himself not only unable to evict the tenant, but defending against the tenant's claim the eviction is:

- **retaliation** for the tenant making official complaints about the property or against the landlord;
- based on **discriminatory reasons**, such as the tenant's ethnicity or marital status; or
- **improper** because of the failure to maintain the property in a habitable condition.

When a tenant's rent is subsidized by the Department of Housing and Urban Development's (HUD) Section 8 housing program, the landlord must set forth **good cause** as the reason for the termination in the 30-day notice to vacate. [**Mitchell** v. **Poole** (1988) 203 CA3d Supp. 1]

Material breaches of a rental agreement, such as a failure to pay monies due or maintain the property, or the creation of a nuisance or illegal use of the property, are handled by 3-day notices to quit, not a notice to vacate. However, in order to terminate a tenancy subject to Section 8, a landlord must first provide the tenant with a separate notice from the 30- or 60-day notice that identifies the inappropriate conduct of the tenant which is the basis for "good cause" to terminate the occupancy. [24 Code of Federal Regulations §247.3(b)]

The requisite 90-day notice to vacate

Under the federal rent control law set to expire on December 31, 2014, an *owner-by-foreclosure (OBF)* who purchase properties at trustee's sales for investment purposes may only terminate a residential tenancy by serving the tenant with a 90-day notice to vacate, unless the tenant holds an unexpired lease agreement enforceable under federal rent control for a longer remaining term. [See **first tuesday** Forms 573 and 573-1; CCP §1161a; Dodd-Frank Wall Street Reform and Consumer Protection Act §1484(2)]

Thus, an OBF cannot use a 90-day notice to vacate to avoid:

- a *bona fide lease agreement* held by the existing tenant, entered into prior to the foreclosing lender recording of an NOD, granting the tenant the right to possession for a period running beyond a 90-day notice period.

- an existing Section 8 or state housing assistance payment contract which subsidizes the tenant's rent; or
- state or local rent control codes or ordinances that provide the residential tenant with a greater time period for occupancy or other tenant benefits such as relocation money. [Pub Law 111-22 §702(a)(2); Pub Law 111-22 §703(2)]

A **bona fide lease** is a lease agreement between the tenant and the prior owner which meets all of the following criteria:

- the lease agreement is an *arm's length lease agreement*, meaning the tenant is not a parent, spouse or child of the prior owner; and
- the lease agreement calls for payment of a fair market rent.

If the tenant remains in possession of the property past the 90-day period and, in the case of an unexpired lease, until the close of the resale escrow to a buyer-occupant, he can be evicted through a UD action. [Pub L 111-22 §702 (a); CCP §1161(5)]

OBF adherence to an existing lease

Consider an OBF who plans to operate the property he bought at a trustee's sale as income-producing property (or resells it to an investor who will hold it as income producing property) and a residential tenant is in possession who was in possession at the time of the trustee's sale.

If the tenant holds a lease agreement which terminates prior to the running of a 90 day notice to vacate, the OBF may serve the tenant with a 90-day notice to vacate to terminate his right to possession. If the tenant does not vacate upon expiration of the 90-day notice, the OBF may have the tenant removed through a UD action. [Pub L 111-22 §702 (a)(1)]

However, if the term remaining on the existing lease terminates on a date beyond 90 days after service of the 90-notice to vacate, the OBF must allow the tenant to remain on the property until the lease is terminated by expiration or on a default, unless resold to a buyer who will occupy the property as his primary residence.

A lease with a term exceeding 90 days at the time of the notice is likely an 18 or 24-month lease, as a one-year lease entered into before an NOD is filed would likely expire on or about the time the entire trustee's sale process is completed and the 90-day notice is served and expired. [Pub L 111-22 §702 (a)(2)(A)]

Additionally, if the lease is subject to the Section 8 voucher program and was entered into prior to the trustee's sale, the OBF must honor the Section 8 voucher program through the end of the lease. [Pub L 111-22 §703 (2)]

Maintenance and security

Chapter 85 — Implied warranty of habitability

This chapter examines the purpose of the implied warranty of habitability and its effect on residential landlords.

For a further discussion of this topic, see Chapter 37 of Real Estate Property Management.

Chapter 85 Outline

Safe and sanitary living conditions
Landlord's breach of the warranty
Pre-leasing maintenance program
Determining reasonable rental value
Landlord has no time to respond
Duty to avoid foreseeable injury
Conditions creating a nuisance

Chapter 85 Terms

Appurtenances	*Major defect*
Constructive eviction	*Nuisance*
Duty of care	*Punitive damages*
Habitability	*Repair and deduct remedy*

Safe and sanitary living conditions

The typical residential tenant under a lease agreement acquires a leasehold interest in the leased property to occupy it for a specific period of time. The tenant expects the premises and appurtenances (e.g., common areas, parking and storage) available to him to be fit for the purpose leased — to be a sanitary place in which he may safely reside.

However, a residential tenant, especially an apartment dweller, is not just acquiring an interest in real estate, he is *contracting* for, and is entitled to, a **safe and sanitary** place to live, called a *habitable dwelling*. [See **first tuesday** Form 550]

The implied warranty requires the residential landlord to care for the premises by maintaining habitable conditions — the minimum level of living conditions for a safe and sanitary dwelling unit permitted by law. [**Hinson** v. **Delis** (1972) 26 CA3d 62; Calif. Code of Civil Procedure §1174.2]

Residential property which is not in a habitable condition cannot be rented or leased "as-is," even though defective property conditions have been fully disclosed and the substandard conditions consented to by the tenant.

The implied warranty applies to the space rented by the tenant as housing and also to common areas the tenant may use, such as laundry facilities, parking, recreational areas and storage spaces, called *appurtenances*. [Hinson, *supra*]

The public policy establishing the warranty of habitability was legislated due to landlords overreaching due to the scarcity of available low-cost housing. This economic situation left residential tenants in lesser socioeconomic neighborhoods without the bargaining power possessed by more affluent and mobile tenants when negotiating with landlords for better property conditions.

Thus, market forces cannot prevail over the higher public policy requiring safe and sanitary housing. The warranty of habitability serves to punish slumlords and discourage slum-like conditions in low-income housing.

A landlord who invests money in real estate must maintain his property. Otherwise, the value of his investment will eventually disintegrate due to competitive pressures in the rental market and court orders.

Landlord's breach of the warranty

The landlord breaches the implied warranty of habitability when the landlord fails to comply with building and housing code standards that *materially affect* health and safety. [CCP §1174.2(c)]

A habitable place to live is a dwelling free of *major defects*, not mere inconveniences, which would interfere with the tenant's ability to use the premises as a residence.

A residential dwelling is **uninhabitable** if any features of the dwelling are not properly maintained or do not **substantially comply** with building and housing codes, including:

- effective waterproofing and weather protection of roof and exterior walls, including unbroken windows and doors;
- plumbing and gas facilities;
- a hot and cold running water system with appropriate fixtures which are connected to a sewage disposal system;
- heating facilities;
- electrical lighting; and
- floors, stairways and railings. [Calif. Civil Code §1941.1]

In applying these guidelines, a leaky faucet would not render a residential unit uninhabitable, despite the inconvenience. However, a lack of running water, or no hot water, is a significant defect that materially interferes with the tenant's ability to live on the property.

At the time the rental or lease agreement is entered into, the building grounds and appurtenances, such as a pool, laundry facilities, storage areas and parking structures, must be clean,

sanitary and free from all accumulations of debris, filth, rodents and vermin to meet habitability guidelines. [CC §1941.1(f)]

Further, the landlord must provide an adequate number of garbage and rubbish receptacles in clean condition and good repair. [CC §1941.1(g)]

A residential tenant in an apartment complex is not typically expected to make repairs to major components of the complex, such as a central heating system, an electrical or plumbing system or the roof.

If a residential landlord fails to make necessary repairs, and the cost of the repair is less than one month's rent, the tenant may order out and pay for the needed repairs and deduct the cost from the rent, called the *repair and deduct remedy*. [CC §1942]

However, the **repair-and-deduct remedy** is not often feasible in apartment dwellings since areas where repairs must be made are in the possession and control of the landlord.

Thus, the residential tenant must resort to other remedies, such as:

- vacating the premises, called a *constructive eviction* [See Chapter 83];
- stop paying rent and, in any ensuing UD action, prove the landlord breached the implied warranty of habitability; or
- raise and prove the defense of retaliatory eviction.

Pre-leasing maintenance program

Before renting a residential unit in a building intended for human habitation, the landlord, in addition to maintaining habitability, must:

- install and maintain an operable **dead bolt lock** on each main entry door of a unit, unless the door is a horizontal sliding door;
- install and maintain operable **security or locking devices** for windows which are designed to be opened, unless the window is a louvered window, casement window, or more than 12 feet vertically or six feet horizontally from the ground, roof or other platform; and
- install **locking mechanisms** on the exterior doors leading to common areas with access to dwelling units in an apartment complex — installation of a door or gate is not required if none existed on January 1, 1998. [CC §1941.3(a)]

A tenant is responsible for promptly notifying the landlord of an inoperable dead bolt lock, window security or locking device in the unit. The landlord will only be liable for injuries caused by his failure to correct the defect within a reasonable period of time after being notified or becoming aware of the defect. [CC §1941.3(b)]

A residential landlord failing to comply with required security measures entitles the tenant to:

- repair and deduct the cost from rent;

- vacate the premises;
- recover money losses incurred due to the condition of an uninhabitable building;
- recover losses caused by any landlord retaliation;
- file an action for breach of contract; or
- seek injunctive relief to stop the landlord from keeping an uninhabitable building. [CC §1941.3(c)]

Determining reasonable rental value

To calculate the **reasonable rental value** of the premises when a breach of the implied warranty of habitability exists, the court will:

- establish the percentage attributable to the tenant's diminished habitability or use of the premises due to the substandard living conditions; and
- use the percentage to reduce the agreed-to monthly rental payment. [**Cazares** v. **Ortiz** (1980) 109 CA3d Supp. 23]

When determining the percentage of habitability or useability lost caused by the landlord's failure to maintain, the criteria includes:

- the **area** of the rental unit affected;
- the **duration** of the tenant's exposure to the defect;
- the **degree of discomfort** the defect imposes on the tenant;
- whether the defect is **health-threatening** or intermittently annoying; and
- the extent to which the defect caused the tenant to find the premises **uninhabitable**. [Cazares, *supra*]

If the agreed-to monthly rent is already below market rent due to the condition of the premises, the landlord who has breached the warranty of habitability may receive only a minimal amount of rent from the tenant. The court-ordered rent properly may be so minimal as to result in a financial penalty to the landlord.

Landlord has no time to respond

The warranty of habitability does not entitle a residential landlord to a reasonable period of time after a tenant takes possession in which he may repair unsafe and unsanitary living conditions before the tenant takes other action, such as withholding rent.

The landlord should not allow a tenant to take possession until the premises is fully repaired.

The warranty of habitability is breached when the need for repairs is:

- known by the landlord, either through notice from the tenant or by the physical state of the property at the time it is rented; and

- the landlord fails to immediately correct the defective conditions.

Landlords have a duty to inspect and maintain their property and improve or correct known substandard conditions before renting it. The “no notice” and “no reasonable time to repair” rules imposed on landlords by the warranty of habitability are based on the notion that landlords are or should be aware of the condition of the physical components of the premises at the time the unit is rented. [CC §1714]

Duty to avoid foreseeable injury

A tenant can recover more than a rent adjustment when the landlord breaches the implied warranty of habitability.

For example, a tenant inspects a rental unit and enters into a month-to-month rental agreement with the landlord. When he takes occupancy of the unit, the tenant discovers faulty electrical wiring, a clogged kitchen sink and a leak in the roof, later damaging the tenant’s personal property.

The tenant notifies the landlord (and the county health department) of the defective property conditions and asks the landlord to make the necessary repairs.

The landlord fails to make any repairs. The tenant continues to reside on the premises.

Eventually, the county health department issues a notice condemning the building as unfit for occupancy. The tenant relocates.

The tenant then makes a demand on the landlord for water damage to his personal property and the cost of relocating to a new residence since the landlord breached his duty of care to repair the defective conditions.

Here, the landlord owes a *duty of care* to the tenant, apart from the warranty the premises be up to minimum standards of habitability, to properly maintain the premises to avoid the risk of a foreseeable financial loss suffered by the tenant and caused by the landlord’s failure to maintain the property.

Thus, the landlord is liable for the costs incurred by the tenant to replace damaged personal property and relocate. The costs the tenant incurred were a result of the landlord’s breach of his duty of care by failing to make the necessary repairs to eliminate unsafe and uninhabitable conditions. [**Stoiber** v. **Honeychuck** (1980) 101 CA3d 903]

Additionally, the tenant can recover excessive rent paid for periods of his occupancy when the unit was uninhabitable.

Even if a residential tenant fails to raise the warranty of habitability defense in a UD action and is evicted or otherwise vacates, the tenant can later recover any excessive rent paid during the period the landlord failed to maintain the unit in a habitable condition. [**Landeros** v. **Pankey** (1995) 39 CA4th 1167]

Conditions creating a nuisance

Now consider a tenant of an apartment unit forced to relocate due to unsafe flooring and unsanitary conditions, causing the local health department to issue an order condemning the apartment complex.

The tenant makes a demand on the landlord to pay his **relocation expenses**, claiming the defective conditions in the rental unit constitute a *nuisance* since he is deprived of the safe and healthy use and enjoyment of the leased unit.

The tenant also seeks the recovery of *punitive damages* from the landlord. The tenant claims the landlord's failure to correct the defective conditions that created the nuisance was intentional and malicious.

The landlord claims the tenant cannot recover losses based on a nuisance, much less receive a punitive award for money, since his interference with the tenant's use and enjoyment of the unit is a breach of the contractual warranty of habitability implied in the lease agreement, not the tortious creation of a health nuisance.

Besides breaching the habitability warranty, the landlord has, by the same conduct, also created a nuisance for the tenant. The landlord's failure to make repairs and properly maintain the rental unit **substantially interfered** with the tenant's continuing **use and enjoyment** of the unit. [Stoiber, *supra*]

A *nuisance* is any condition that:

- is injurious to health;
- obstructs the free use of property; or
- interferes with the comfortable enjoyment of property. [CC §3479]

Further, the landlord's continued failure to maintain and repair the premises in a safe condition during the health department's investigation and condemnation action indicates the landlord **intentionally maintained** a nuisance on the premises — an ongoing disregard for the safety and health of the tenant.

Besides recovering his out-of-pocket losses to relocate, the tenant is entitled to an award for an additional sum of money, called *punitive damages*, since the landlord maintained a nuisance due to his intentional failure to repair. [Stoiber, *supra*]

Further, the landlord's liability to the tenant for creating a nuisance is additional to any refunds of rent and rent reduction for breaching the warranty of habitability in the rental agreement.

The tenant can also recover from the landlord any medical expenses and personal injury due to an intentional infliction of **mental distress** if the landlord's failure to maintain the unit in a habitable condition is the result of the landlord's extreme and outrageous conduct. [Stoiber, *supra*]

Chapter 86 — Security to prevent crimes

This chapter clarifies the responsibility of the landlord to reduce the risk of crime through prevention when he has knowledge of criminal activity on the leased premises.

For a further discussion of this topic, see Chapter 39 of Real Estate Property Management.

Chapter 86 Outline

Protective measures and warnings
Degree of foreseeability of harm
No liability if not foreseeable
On-site, not off-site prevention
Prevent dangers within your control
Ability to control is not control

Chapter 86 Terms

Criminal activity *Foreseeability of injury*

Protective measures and warnings

A landlord of an apartment complex is aware of recent assaults on tenants in the common areas of the property. The landlord has also received a composite drawing of the criminal and a description of the criminal's mode of operation released by the local police.

The landlord does not undertake any of the security steps available to reduce the risk of a recurrence of the same or similar criminal activities.

The landlord later rents a unit to a prospective tenant. The landlord does not disclose the recent **criminal assaults** or the criminal's mode of operation. The tenant is not given a copy of the composite drawing of the perpetrator developed by the police. Further, the landlord represents the complex as safe and patrolled by security.

Later, the tenant is assaulted by the same perpetrator inside the tenant's apartment unit, not in the areas open to the public. The tenant seeks to recover his money losses caused by the assault from the landlord. The tenant claims the landlord failed to disclose the prior assaults and misrepresented the safety of the apartment complex to induce the tenant to rent and occupy the unit.

The landlord claims he is not liable for the tenant's injuries since the assault occurred within the tenant's apartment unit and not in the common areas where the prior attacks occurred.

Here, the landlord is liable for injuries suffered by the tenant inside the apartment unit. The landlord knew of criminal activity on the premises and thus **owed a duty** to care for and protect the tenant by either:

- providing security measures in the common areas; or
- warning the tenant of the prior assaults. [**O'Hara** v. **Western Seven Trees Corporation Intercoast Management** (1977) 75 CA3d 798]

Based on the prior occurrences of criminal incidents, the likelihood of similar future assaults on tenants is *reasonably foreseeable*. When criminal activity is **reasonably foreseeable** due to known prior criminal activity, the landlord has a duty to take reasonable measures **to prevent harm** to persons on the property from future similar criminal activities.

Degree of foreseeability of harm

Consider a landlord of a shopping center who has exclusive control over the maintenance and repair of the common areas. Burglaries and purse snatchings have recently occurred on the premises.

However, the landlord is unaware of this criminal activity in the shopping center.

At tenant association meetings, concerns about the lack of security in the center are addressed. The tenant association decides not to hire security guards on account of the expense. The tenants do not discuss or bring their security concerns to the attention of the landlord.

Later, a tenant's employee is physically assaulted and injured on the leased premises. The employee claims the landlord is liable for his injuries since the landlord failed to provide security guards to protect employees of tenants from an unreasonable risk of harm.

The landlord claims he is not liable since the assault on the tenant's employee was a type of crime that was unforeseeable.

Here, the landlord has no duty to provide security guards in the common areas. The prior crimes (theft) were not of a similar nature that would have made a physical assault foreseeable. [**Ann M.** v. **Pacific Plaza Shopping Center** (1993) 6 C4th 666]

The landlord's duty to provide protection is determined in part by balancing the foreseeability of harm against the **burden imposed** on the landlord to remove or prevent the harm. A high degree of foreseeability is necessary to impose a duty on a landlord or HOA to hire security guards.

Unless prior incidents of **similar crimes** are brought to the landlord's attention, the high degree of foreseeability required to impose a duty on the landlord to take steps to prevent or eliminate future injury does not exist.

However, **prior similar incidents** are not always required to find that a landlord has a duty to take measures to prevent future criminal activity. The *foreseeability of an injury* is determined by the circumstances surrounding the injury and its occurrence, such as the nature, condition

and location of the premises, and any prior incidents of similar or related activity in and around the premises. [Ann M., *supra*]

No liability if not foreseeable

The extent of the security measures a landlord is required to provide is dictated by the degree of foreseeability of any future harm to others. [Ann M., *supra*]

If an injury is not foreseeable since the **nature, condition and location** of the leased premises do not indicate a person entering or using the property is at risk, a landlord is not liable if an injury, which security measures may have prevented, occurs on the premises.

Consider an apartment complex where previous criminal activity has not occurred. However, the community where the complex is located is generally known as a high-crime area.

The light bulb installed at the entrance to a tenant's apartment burns out. The tenant asks the landlord to replace the light bulb. The lighting in the common area is functional.

Before the landlord replaces the bulb, the tenant is assaulted in his unit, suffering injuries. The tenant claims the landlord is liable for his injuries since the landlord has a duty to provide adequate lighting as a security measure.

The landlord claims he is not liable since the light bulb outside the tenant's unit is for the tenant's convenience, and is not intended as a security measure to protect tenants.

Here, the landlord is not liable. Prior criminal activity had not occurred on the premises that would put the landlord on notice of foreseeable risks. Thus, the landlord has no duty to take security precautions against criminal activity. Further, lighting alone is not considered an adequate security measure for deterring crime. [**7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901]

On-site, not off-site prevention

Tenants occupying an apartment complex have been victimized by numerous assaults and robberies in the garage area and courtyard. The landlord is aware of the criminal activity **on the premises**. In response to tenants' complaints, he promises to install additional lighting.

A tenant parks on the street instead of in the garage due to the inadequate lighting in the common areas. One night, while parking on the street, the tenant is attacked and injured. The tenant claims the landlord is liable for his injuries since the landlord's failure to provide adequate on-site lighting created a dangerous condition, forcing him to park on the street.

Is the landlord liable for the tenant's injuries that occurred on a public street?

No! The landlord does not have a duty to protect a tenant from criminal acts committed by others that injure the tenant when he is not on the leased premises. [**Rosenbaum** v. **Security Bank Corporation** (1996) 43 CA4th 1084]

Prevent dangers within your control

The landlord's duty of care is derived from his **ability to prevent** the existence of dangerous conditions from existing on the **property he controls**, not adjacent properties or public right of ways over which he has not taken control. A duty of care toward tenants is owed by the landlord only when a **connection exists** between the harm suffered by the tenant and the landlord's care and maintenance of his property and any adjacent property over which he takes control.

Ability to control is not control

Now consider a landlord who is aware of criminal activity occurring on public property adjacent to the leased premises. A visitor leaves the leased premises at night via a public sidewalk adjacent to the premises. Lighting is not installed on the public side of the premises to illuminate the sidewalk.

While walking on the public sidewalk, the visitor is assaulted and injured. The visitor makes a demand on the landlord to recover money losses incurred due to his injuries. The visitor claims the landlord has a duty to protect patrons of tenants from criminal assaults on public sidewalks that provide access to the premises.

The visitor contends the landlord knew criminal activity had occurred on the sidewalk and **had the power** to exert control over the sidewalk by installing lights on the outside of the building — the sidewalk was the means of ingress and egress to the building.

Is the landlord liable for the client's injuries due to a dangerous condition on adjacent property?

No! The landlord does not owe a duty of care to anyone to take control over adjoining property and remove or prevent injury from dangerous conditions existing on the adjoining property.

The landlord is not liable for failing to take steps to prevent possible injuries from occurring on a public sidewalk adjacent to the leased premises that are regularly used by tenants for access to their units. [**Donnell** v. **California Western School of Law** (1988) 200 CA3d 715]

Construction

Chapter 87 Construction concepts

This chapter comments on the regulations controlling the construction of residential and commercial properties in California, the basic construction and architectural concepts all agents should be conversant in and reviews the California Home Energy Rating System (HERS).

Chapter 87 Outline

Building regulations
Role of a contractor
Roofing components
Construction basics
Home energy information
Let the energy ratings begin

Chapter 87 Terms

Building inspector	*Foundation walls*
Building permit	*General engineering contractor*
California Building Standards Code	*Home Energy Rating System*
Certificate of occupancy	*Masonry*
Department of Housing and Community Development	*Orientation*
Drywall	*Rafters*
Floor plan	*Specialty contractor*
General building contractor	*Square footage*

Building regulations

Construction of residential and nonresidential buildings is regulated by the state of California through *building codes*.

The *State Housing Law* outlines the construction requirements and standards for all buildings in California. The **Department of Housing and Community Development (HCD)** *(www.hcd.ca.gov)* is responsible for adopting administrative regulations to carry out the provisions of the **Housing Law** in the construction and occupancy of dwellings, including hotels, motels, apartments and houses.

The HCD establishes building standards and codes, called the *California Building Standards Code*. [24 Code of Federal Regulations §3280 et seq.]

Local governments can amend building codes to meet the particular needs of its community based on local climactic, geological or topographical conditions. However, local building codes must comply with state regulations.

Building codes are enforced by *building inspectors* at the local level. Prior to beginning construction, a *building permit* must be obtained from the local building department. Once construction is complete, a building must pass inspection and receive a *certificate of occupancy* before allowing occupancy. A temporary **certificate of occupancy** can be issued to allow occupancy while minor construction is still underway.

The **California Department of Public Health** may stop the construction of a property if its water supply, sewage or drainage system is impaired.

Standards for the construction of mobilehomes are governed by the **Department of Housing and Urban Development (HUD)** in Title 24 of the Code of Federal Regulations. [24 CFR §3280 et seq.]

Role of a contractor

A *contractor* is anyone who offers or agrees to construct, alter, repair, improve or demolish any building, road, project, development or improvement. [Business and Professions Code §7026]

Anyone who acts as a **contractor** in California must be licensed by the **California Department of Consumer Affairs Contractors State Licensing Board** *(www.cslb.ca.gov)* and post a bond or cash deposit. Contracting without a license is a misdemeanor, unless exempt from licensing requirements. [Bus & P C §7028(a)]

Exemptions from the contractor's licensing law include:

- any work performed, including labor and materials, for less than $500 [Bus & P C §7048];
- any work performed by the owner of the property [Bus & P C §7044];
- any work performed by a public utility [Bus & P C §7042];
- oil and gas operations [Bus & P C 7043]; and
- work performed for agricultural purposes.

The status of a California contractor's license can be verified online at *www.cslb.ca.gov* under the "Online Services" tab.

There are three types of contractor's licenses a contractor may hold:

- *general engineering*;
- *general building*; or
- *specialty*.

Architectural styles

There are numerous architectural styles found in California. The different architectural styles include:

- *colonial*, also called *Cape Cod*;
  - traditionally featuring wood siding and shutters with a steep wood-shingled roof.
- *Dutch colonial*;
  - traditionally featuring a gambrel roof and dormer windows.
- *Victorian;*
  - traditionally multiple stories and featuring ornate wood external decorations and high ceilings.
- *town house*;
  - traditionally located in more densely packed urban areas, **town houses** share a common wall with the neighboring property.
- *English Tudor*;
  - traditionally featuring timber framing and a steep, gable roof.
- *French provincial*;
  - traditionally multiple stories and featuring a hip roof with brick exterior.
- *Spanish*;
  - traditionally one story with a light colored stucco exterior and featuring an orange or tan tile roof.
- *ranch*;
  - traditionally one story with a wood or masonry exterior and an attached garage.
- *contemporary*.
  - traditionally constructed recently and featuring an open floor plan and minimal ornamentation.

A **general engineering** contractor is a contractor whose principal business requires specialized engineering knowledge and skill, such as irrigation and drainage, flood control, streets and roads, bridges, etc. [Bus & P C §7056]

A **general building** contractor is a contractor whose principal business is the construction of any structure designed for occupation by people, animals or personal property. [Bus & P C §7057]

A **specialty contractor** is a contractor whose principal business is a specialized trade or craft, such as servicing fire extinguisher systems, laying carpet or linoleum, or preparing or removing roadway construction zones. [Bus & P C §7058]

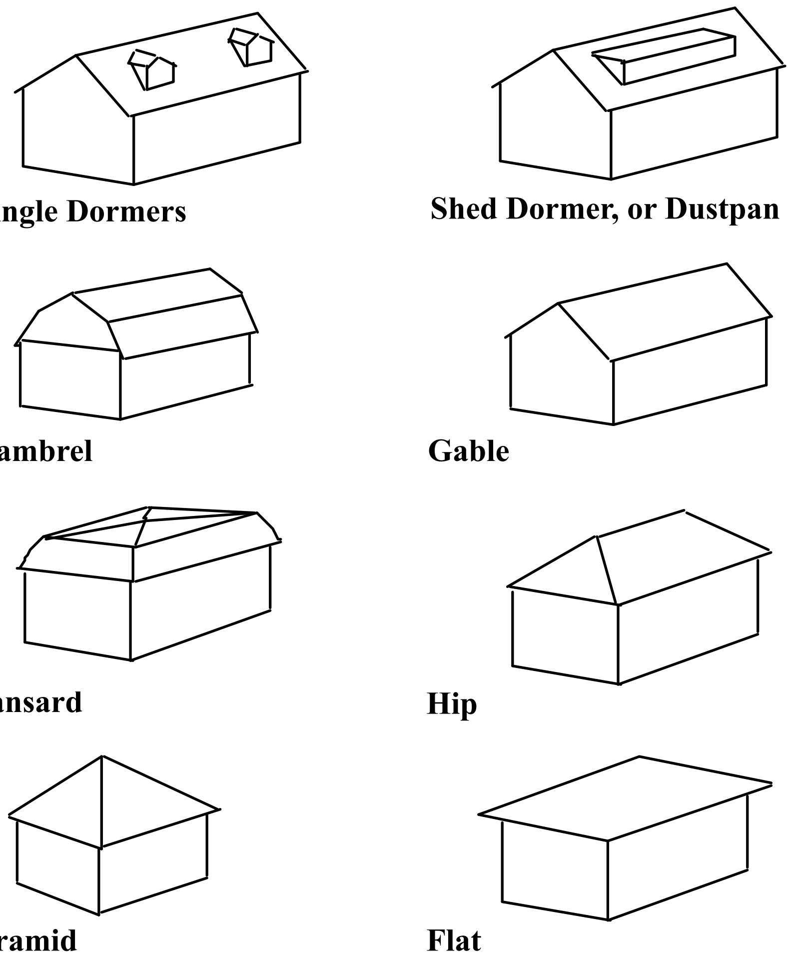
Contractors may hold all three types of licenses concurrently. [Bus & P C §7059]

Contractors engaging in **asbestos-related work** that involves more than 100 square feet of surface area of asbestos must pass an asbestos certification and be registered with the Division of Occupational Safety and Health Department of Industrial Relations. [Bus & P C §§7058.5; 7058.6]

Further, for the removal or remedial maintenance of hazardous substances, contractors must pass a hazardous substance certificate examination. This includes the installation or removal of underground storage tanks. [Bus & P C §7058.7]

A contractor’s license may be suspended or revoked if the contractor:

Figure 1



Images courtesy of the California Department of Real Estate (DRE) and featured in the DRE’s ***Reference Book: Information Relating to Real Estate Practice, Licensing and Examinations****. This publication is available on the* ***first tuesday Unlocking the DRE Exam – Your Quickstart Career Kit*** *Bonus CD-ROM.*

- violates safety or building regulations [Bus & P C §7110];
- breaches the construction contract in a material respect or fails to follow the plans or specifications [Bus & P C §7109];
- abandons an incomplete project [Bus & P C §7107]; or
- diverts funds received for the completion for a specific project or fails to substantially account for the use of the funds. [Bus & P C §7108]

Roofing components

Rafters form the shape of a roof. Sheathing, made of plywood or a wood product called *oriented strand board (OSB)*, is placed on top of the **rafters**, which serves as a base for the *finishing material*. The **finishing material**, such as composition roofing, shingles, wood shakes, slate or tile, is layered over the rafters and sheathing, forming the roof. Where the rafters rise to meet the *ridge board* at the apex of the roof is known as the *ridge*.

Sheet metal called *flashing* is placed around the openings in the roof for vents and chimneys and along edges. A flat roof, most commonly used on commercial properties, is covered with a protective layer, such as felt, and coated with tar and gravel, commonly known as a *traditional built-up hot-mop roof*.

Another commonly used method of finishing a roof is called *torch-down roofing*, in which rolls of protective layering made of rubberized asphalt are unrolled over the surface of a roof then heated with a blowtorch to melt the under layer of asphalt, binding it to the surface of the roof.

The portion of the roof that extends over the exterior wall of the house is called an *eave*. A gutter runs along the eave to catch and direct rain runoff through the downspout.

The following are types of roofs found on homes:

- single dormers;
- shed dormer or dustpan;
- gambrel;
- gable;
- mansard;
- hip;
- pyramid; or

- flat. [See Figure 1]

Construction basics

The placement of a house upon the lot is referred to as its *orientation*. **Orientation** is the key determinant of a property's sun exposure, and the advantages and disadvantages of a particular orientation will vary depending on geography.

The *floor plan* of a house refers to how its internal space is arranged and allocated. An advantageous **floor plan** allows easy mobility and circulation through the improvements as well as convenient access to living areas, shared rooms and restrooms.

Some homes are built upon a *foundation*. The **foundation walls**, anchored by footings, are supports typically made of formed concrete, concrete block or masonry on which woodframe houses usually rest. In some older homes, river rock or stone was used to form the foundation walls.

Unreinforced masonry walls used for structural purposes are earthquake hazards that must be disclosed by providing the buyer with a copy of the *The Homeowner's Guide to Earthquake Safety* for pre-1975 residential or nonresidential buildings. [Government Code §8875.6; see **first tuesday** Forms 315-1 and 316-2; see Figure 2, excerpt from **first tuseday** Form 316-1]

After the construction site is excavated, the concrete foundation walls are poured into wood forms. Once the concrete has dried, also referred to as *cured*, the wood forms are removed and *dirt backfill* is packed against the walls. Placed directly on top of the foundation wall is the *mud sill.* Wood beams on which the floor of the house rests are called *girders* and *joists*.

A *crawl space* is sometimes left under a home to provide protection against termites and pests and provide a space for ventilation.

Radon gas is a naturally occurring gas which results from the erosion of uranium in soil. **Radon gas** is harmless in well ventilated areas but can accumulate in confined areas, such as **crawl spaces** and **basements**, posing a health risk to occupants. [See Figure 2, excerpt from **first tuseday** Form 316-1]

Other properties are built on a *concrete slab*, anchored by footings. Properties built on a slab are not elevated upon foundation walls, nor do they have a crawl space.

Once the foundation walls or slab have been laid, the *frame* of the house is erected. The **frame** is the skeleton of the house to which interior and exterior walls are attached. Vertical supports within the frame are called *studs.*

The standard spacing for **studs** is *16" on center* (measured from the center of each stud) for **load-bearing walls**. Some non-load-bearing interior walls, also known as *partition walls,* allow a spacing of 24" on center. Fire stops are horizontal pieces of material placed between the studs to block air drafts.

The **exterior walls** consist of sheathing, which may come in the form of structural plywood or OSB. Outside of the sheathing, the *siding* is placed. **Siding** can be wood, brick, stone, masonry, aluminum, stucco, cement board or other materials.

Home energy information

As California's energy supply adjusts to population growth and new technology, the search is on for renewable local energy sources and innovative ways to further increase a home's energy efficiency. Buyers and sellers of real estate are becoming increasingly aware that a household is a heavy consumer of electricity, gas and other fuel sources, the use of which must be monitored and rationed wisely.

Utility bills are volatile and have always been an important cost factor to be disclosed to buyers when they are considering homeownership. However, most individuals do not realize that the actual structure of the home they live in can have a positive or negative impact on the monthly cost of their energy consumption. More than just turning off unused lights or running the sprinklers fewer times a week, the way a home is built has a drastic impact on how much energy it needs and expends to lower or raise the temperature, heat water and power appliances.

The federal *Home Energy Score* assigns a rating to each home determined by an energy specialist called a *Home Energy Rater (Rater)*.

Using this **rating system**, buyers can determine how much energy the home expends and causes inhabitants to expend due to its current structural condition and location. Homes with a high score require the expenditure of a large amount of energy, while homes with low scores are more efficient and better located. For homeowners and sellers, the specialist will suggest changes to improve the score.

Under the *California Home Energy Rating System (HERS) program*, **raters** are trained through both classroom and field work in the theories of energy conservation, analysis of a structure's energy related components and the practical application of the training on the following subjects:

- home energy consumption;
- efficiency data collection, organization and analysis;
- principles of heat transfer;
- building energy feature design and construction practice;
- safety practices relevant to home energy auditing procedures and equipment;
- home energy audit procedures;
- energy-efficiency effects of building site characteristics;

- types and characteristics of space heating, space cooling, service hot water and hard wired lighting system; and
- methods of cost-effectiveness analysis including interest and discount rates, cost-benefit ratios, life cycle cost analysis, calculation of present value, cash flow analysis, payback analysis and cost estimation. [See **first tuesday** Form 150 §11.1]

Let the energy ratings begin

The California Energy Commission designed and implemented the HERS program to include a uniform **rating scheme** for the systematic delivery of home energy ratings to homeowners by certified Raters.

The HERS Rating Index covers:

- space heating/cooling;
- service hot water;
- lighting in conditioned space;
- exterior lighting mounted on buildings or unconditioned garage;
- electric/gas appliances; and
- other interior electric and gas uses specified in the HERS Technical Manual.

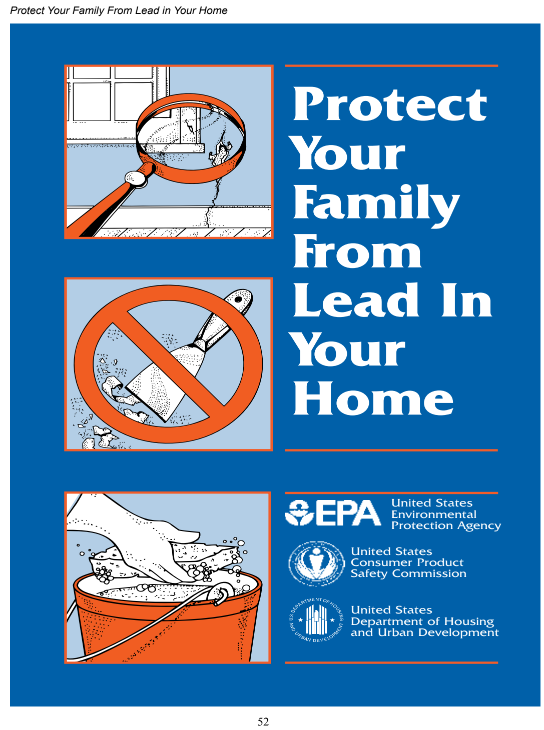
The Rater then uses all of these factors to give the home a *California Whole-House Home Energy Rating (energy rating)*.

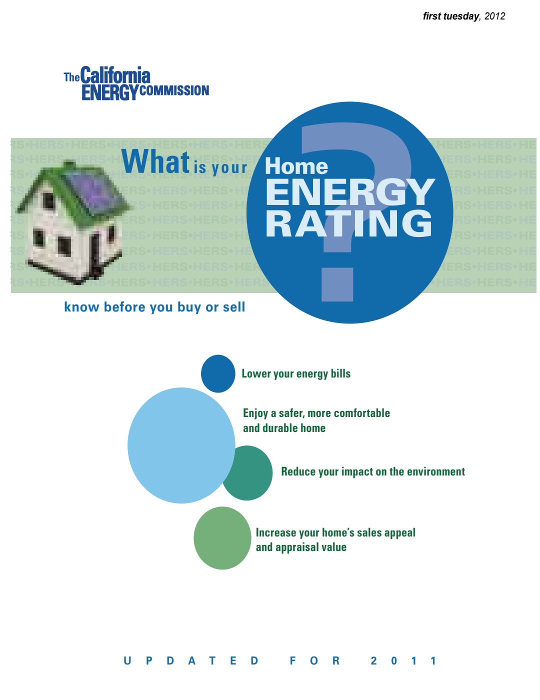
The **energy rating** is a numerical representation taken from the *Time Dependent Valued (TDV)* energy scale. The **TDV** numerical rating represents the level of energy consumed, produced and delivered to the home. The TDV is calculated by the Rater using an hourly energy consumption simulation program approved by the Energy Commission.

The numerical scale for TDV ratings runs from zero to 150. Zero represents a home which produces as much or more energy than it consumes. A rating of 100 represents a standard new home built with current energy standards. A rating of over 100 indicates the home does not meet present energy standards for new construction. [See **first tuesday** Form 150 §11.1(h)]

The final step in the Rater's assessment includes recommendations for energy efficient improvements for the home he has inspected. The Rater will list the cost-effective improvements he believes will upgrade the energy-efficiency of the home.

Figure 2 *Excerpts from **first tuesday** Form 316-1 - Residential Environmental Hazards Disclosure Booklet for Buyers*





Scan this QR-Code for a PDF of the Form!

Chapter 88 — Blue prints for construction

This chapter comments on the function of public controls to guide the uniform growth of a municipality, with an eye on the government actions necessary to promote growth in the construction and real estate industries.

Chapter 88 Outline

Controlled growth
The need for government action
Revisit height restrictions
Centralized growth
Construction in the future

Chapter 88 Terms

Common interest development (CID)	*Public report*
Planning commission	*Subdivided Lands Act*
Public control	*Subdivision Map Act*

Controlled growth

New construction must be performed in conformance with *public controls*.

Without **public controls**, growth would become erratic, creating the potential for numerous public problems, such as poor access to public areas, inadequate streets and parking, inconsistent architectural design and utility, poor air quality, and insufficient public services, such as police and fire protection.

Further, public controls ensure property values are protected and not undermined by unchecked growth (or deterioration).

Public controls are enacted through:

- state laws;
- zoning regulations;
- local general and master plans; and
- building codes.

Every city and county has a *planning commission*, also referred to as a *planning department*, tasked with developing and maintaining the adopted **general plan** governing the growth of a municipality. [Calif. Government Code §65000 et seq]

A general plan sets forth the acceptable land uses within a jurisdiction, including a statement of development policies on:

- land use;
- circulation patterns;
- housing;
- conservation;
- open space;
- noise; and
- safety. [Gov C §65302]

The planning commission maintains the general plan by making recommendations on zoning proposals, subdivision regulation, use permits, variances and other development permits related to general plan goals and policies.

Subdivision regulation is the primary method of implementing the general plan. Local agencies may not approve a **tentative map** for a project when the subdivision has been found by the planning commission to be inconsistent with the adopted general plan or any specific plan. [Gov C §66473.5]

A city or county may also control the physical aspects of a subdivision. A subdivider must prepare a map of a proposed *common interest development (CID)* for approval by the local planning commission prior to commencing construction of the project. [Gov C §66410 et seq.]

The *Subdivision Map Act* establishes the conditions for approval of a subdivision map, and provides the planning commission the authority to regulate the design and physical improvements to be installed in a CID. [Gov C §66411]

Further, the *Subdivided Lands Act* authorizes the Real Estate Commissioner to administer the **Subdivided Lands Law** to protect buyers from misrepresentation or fraud in the initial sale of a subdivided property of 160 acres or less. [Calif. Business and Professions Code §11000 et seq.]

A subdivision cannot be sold in California until the Commissioner has issued a *public report* available to buyers which references critical information and provides disclosures about the project. [Bus & P C §11018]

The need for government action

Like many aspects of real estate, the construction industry in a given area tends to be most reflective of the local economic environment, including the actions of *local governments*. To meet the expected demand for housing in urban centers, apartment and *condominium (condo)* builders will need the state legislature to set aside inner city locations for high-density, high-rise residential lodgings.

In fact, for construction to recover most quickly and efficiently, it will be necessary for policymakers to increase the minimum number of residential units permitted per thousand square feet of ground, and to permit mixed uses (both residential and non-residential) within the same structures. Suburban sprawl has proven to be a poor long-term housing and retail strategy, in spite of the appeal of a mythic stand-alone-home on the prairie

Local governments have a great deal of control over real estate price movement, although that control is rarely the subject of rational discussion in California.

As the demand for any type of improved property increases, and prices begin to move upward faster than the rate of consumer inflation (the point in time at which excess asset inflation sets in), local governments must permit the **higher and better use** of existing subdivided parcels (beginning with the demolition of obsolete structures) so that construction can take place to meet demand without delay.

Revisit height restrictions

To accomplish these goals efficiently, cities must implement zoning that allows greater height for buildings and higher urban density. Also, **smart zoning** keeps down the need for new infrastructure to connect existing infrastructure with newly developed properties on peripheral unsubdivided lands.

Successful zoning laws will be those that keep demand for government services at a consistent level by allowing builders to demolish obsolete and inefficient structures and construct high density housing on existing blocks and parcels within the cities. Thus, the need to extend roads and utilities (which the cities will then be required to maintain) is avoided.

Local governments' first responsibility for housing is to revisit current limits on height, density and onsite parking, as well as the mix of unit types (1-, 2- or 3-bedroom units).

These limitations need to be modified with an eye toward the best use of inner city parcels, which are now occupied by old, obsolete SFRs.

Intelligent zoning will allow builders to meet the needs of homeowners and renters looking for jobs in the city's core financial, governmental, educational, medical and other high-end service trades: this century's growth industries for last century's loft buildings. The state legislature has already established a pattern of increasing density by adding low-income units to the permitted use, including authorization to construct granny flats (casitas) for SFRs everywhere. [Gov. C §65852.2]

Centralized growth

City councils can increase building activity for marketable housing by reducing permit costs for the construction of units on central city parcels where additional infrastructure such as roads, sewers and utilities are not required.

Such cost-less policies encourage builders not to jump outward from the urban center into remote unsubdivided lands, and are an intelligent way to make cities more favorably centralized while delivering the convenient apartments and condos urban-dwellers most desire. Given the choice, most prefer to live near to where they work.

As such, government policies to prevent construction will often persist when they are no longer helpful, and incentives created during a recession may come too late and remain even when the market has improved, leading to overbuilding and other evils.

Moreover, local governments are motivated by needs other than those of homebuyers or the construction industry. Among their other concerns, governments must always maintain their own revenue from the tax base.

One way of ensuring this revenue is to encourage construction during slow times, even in the absence of demand from homebuyers, so that the assessment rolls will grow. Such incentives are welcomed by builders, but excess inventory has in the past led to suburban sprawl, unacceptable designs and failure of onsite and offsite amenities – conditions helpful to no one.

Construction in the future

The *rate of homeownership* in California has declined dramatically in recent years, from 60% in 2006 to 55% in 2011 (that rate is likely to be 54% in 2012, and still dropping fast). Anticipate a bottoming of this trend at around 50% homeownership in California by 2017.

This drop in the population's homeownership rate represents 1,020,000 families who had owned and occupied homes in California, and who are now renters due to the housing crash. Almost all of these former owners will continue renting until the *Lesser Depression* is over and their credit scores have been repaired, sometime around 2017.

While much of this shift is due to the challenges presented by failed job opportunities in the *Great Recession* and ongoing Lesser Depression, many foreclosed and shortsale homeowners have left homeownership of SFRs permanently.

Those prior homeowners will continue to rent once the current period of economic stagnation is over. This shift away from homeownership will interfere with detached SFR starts for a long time, although it will bolster construction and investment in multi-family units (rentals).

Construction will first begin to blossom in the communities of **coastal California**, where high-tech information and service jobs are increasingly centered. Coastal communities also have the benefit of appealing to the retiring population, due to their temperate climate and reputation for comfort.

Anticipate increased construction along the coast, especially of multi-family units located in core urban centers, beginning as early as 2012 and climbing steadily, and possibly quite rapidly, throughout the decade.

The pace of SFR starts will be slower to increase, but will follow with an upturn in demand around 2016.

The inland valleys, on the other hand, will remain burdened by excess housing for some time to come. Their current populations are likely to flee in large numbers to the cities, to be closer to jobs and civic amenities, to be replaced with lower-earning, unskilled and immigrant populations.

It will be far into the future before the **Inland Empire** and the **Central Valley** are able to return to the construction levels of the boom years. They will, however, be helped by an increase in industrial employment, as industries move inland to take advantage of the readily available low-income labor. The highway and airport infrastructure already exists.

Chapter 89 — Mechanic's liens and foreclosures

This chapter lays out a subcontractor's right to record a lien on title to a construction job site and the notices required to perfect and foreclose on that lien.

Chapter 89 Outline

Perfecting claims for landlord materials
Preliminary notices
Locating the construction lender
An enforceable mechanic's lien
Mechanic's lien recording period
Foreclosing the mechanic's lien
Notice of Nonresponsibility

Chapter 89 Terms

20-day preliminary notice	*Mechanic's lien*
Actual knowledge	*Notice of Cessation*
Constructive notice	*Notice of Mechanic's Lien*
Contractor	*Notice of Nonresponsibility*
Judicial foreclosure	*Public record*
Labor and materials	*Subcontractor*

Perfecting claims for landlord materials

Contractors and subcontractors have a **constitutionally protected** right to file a mechanic's lien against property they have improved should they not be paid for labor and materials. [California Constitution, Article XIV §3]

A **mechanic's lien** entitles the general contractor or subcontractor to foreclose on the job site property to recover the amount due to him and unpaid under his contract for the labor and materials he supplied. [Calif. Civil Code §8400]

However, the mechanic's lien remedy is only available to contractors and subcontractors whose right to be paid has been *perfected*.

Subcontractors **perfect** their right to payment differently from general contractors since subcontractors do not enter into contracts directly with a property owner.

For a subcontractor to perfect his right to enforce a mechanic's lien against the ownership of the job site by foreclosure, a **20-day preliminary notice** must be served on the appropriate parties. [CC §8200(d)]

Before a subcontractor employed by the general contractor can record a mechanic's lien against the property and enforce it by foreclosure, he must serve a **20-day preliminary notice** on:

- the owner;
- the general contractor; and
- the construction lender. [CC §8200]

The **20-day preliminary notice** informs the owner of the property and the lender that the subcontractor has the right to record and foreclose a mechanic's lien against the owner's interest in the property if the subcontractor is not paid for his labor and materials.

The 20-day preliminary notice is not a notice of nonpayment. Rather, it is a notice which informs the relevant parties (the owner, the general contractor and the construction lender) that the subcontractor has been or is supplying labor and materials to the property. [CC §8202]

In contrast to subcontractors, a general contractor's right to a mechanic's lien is **perfected** when he and the property owner enter into an agreement calling for the general contractor to deliver labor or furnish material to the job site, directly himself or through subcontractors. However, he must still provide a 20-day preliminary notice to the construction lender, if one exists. [CC §8200(e)(2)]

Preliminary notices

The 20-day preliminary notice for private work must include:

- a description of the equipment, materials, services or work performed and an estimate of the price;
- the name and address of the person giving the notice, the general contractor, the owner of the property and the construction lender (if any);
- a description of the job site location; and
- a statement of a contractor's lien rights. [CC §8202]

The preliminary notice must be served within **20 days** after the general contractor or subcontractor first furnishes labor, service, equipment or materials to the job site, commonly called *labor and materials.* [CC §8204]

A general contractor or subcontractor who serves the preliminary notice more than 20 days after first providing labor, service, equipment or materials is barred from using the mechanic's lien for amounts of money owned for labor or supplies delivered prior to the 20 day period.

The general contractor or subcontractor may only assert a claim under a mechanic's lien for nonpayment of labor and materials furnished beginning 20 days prior to service of the preliminary notice. [CC §8204(a)]

Further, if a general contractor or subcontractor fails to serve the 20-day preliminary notice prior to recording his mechanic's lien, the mechanic's lien is invalid. A subcontractor is subject to disciplinary action by the **Registrar of Contractors** for filing a mechanic's lien without first giving the 20-day preliminary notice if the subcontract exceeds $400. [CC §§8200(c); 8216]

Locating the construction lender

A general contractor or subcontractor must check the *public record* to identify the **construction lenders** he must serve with a 20-day preliminary notice before his right to be paid and later record and enforce a mechanic's lien for nonpayment is established.

Identification of the construction lender in the **public record** is accomplished by checking the county recorder's office for any construction trust deeds recorded on the job site, and the county zoning office, the City Department of Building and Safety or any other agency which makes building permit information available for public inspection.

Agencies authorized to issue building permits provide space on their building permit application forms for entry of the construction lender's name and address. [CC §8172(a)]

It must be noted in the space provided in the building permit application if the construction lender is unknown at the time the general contractor applies for the permit. [CC §8172(a)]

An enforceable mechanic's lien

A mechanic's lien is an unnotarized statement signed by the general contractor or subcontractor and recorded.

To be enforceable, a mechanic's lien must be served by mail to the owner of the property on which the labor was performed. This service must be evidenced by a certificate of mailing.

If the owner cannot be identified, the mechanic's lien must be served by mail to the construction lender or general contractor.

Additionally, a mechanic's lien must contain:

- the dollar amount of the general contractor's (or subcontractor's) unpaid demand for labor and materials;
- a description of the labor involved;
- an identification of the property on which the labor was performed;
- the name of the property owner, if known;
- the name of the general contractor, if the mechanic's lien is filed by a subcontractor;
- the address of the general contractor (or subcontractor) recording the lien;
- a completed proof of service affidavit with the date, place, manner of service and recipient of service, signed by the person serving the copy of the mechanic's lien; and

- the statutory "Notice of Mechanic's Lien" statement, printed in at least 10-point boldface type with the last sentence in uppercase type. [CC §8416]

Further, a mechanic's lien is invalid if:

- the lien was created with the intent to defraud; or
- an innocent third party takes possession of the property and is not made aware of the lien due to the lien being deceptively deficient.

All rights under a mechanic's lien will be forfeited if the claimant willfully includes in a mechanic's lien any labor, services, equipment or materials not provided for the property described. [CC §8422]

Mechanic's lien recording period

A mechanic's lien may be recorded after the general contractor or subcontractor has made a demand for payment and payment has not been tendered and received.

Time limitations exist for recording a mechanic's lien after *completion or cessation* of construction on the job site. Notices of completion or cessation are recorded by the owner of the property being improved to reduce the period during which the mechanic's lien must be recorded in order to be enforceable by foreclosure.

Thus, **recording a notice** of completion or cessation of labor is financially important to the owner since recording commences the time period which cuts off any further claims. To reduce the period in which an enforceable mechanic's lien can be recorded, the owner must:

- record the notices of completion and/or cessation; and
- serve a copy of the notice via mail within 10 days of the date of the recording to the contractor and any subcontractor who delivered a preliminary notice. [CC §8190]

Editor's note — Owner-occupants of one-to-four unit residential properties are exempt from having to serve a copy of the notice, but are still subject to the recording requirement. [CC §8190(d)(2)]

A *notice of completion* may be recorded by the owner in the county where the property is located within 15 days after completion of construction. [CC §8182(a)]

Editor's note — If two or more general contractors are performing work on the property, the owner may record a partial notice of completion for each general contractor's portion of labor. [CC §8186]

A *notice of cessation* may be recorded by the owner in the county where the property is located 30 days after cessation of all onsite labor when the project is not completed. [CC §8188(a)]

However, if a **notice of cessation** is not recorded, a 60-day cessation of labor is **considered completion** of the construction project and commences the limitation period for recording a mechanic's lien. [CC §8180(a)(3)]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDERS USE

NOTICE OF NONRESPONSIBILITY

From Landlord (California Civil Code §3094)

Prepared by: Agent ______________________ Phone ______________________

Broker ______________________ Email ______________________

DATE: ____________, 20_____, at ____, California.

NOTICE IS HEREBY GIVEN:

1. ____ is the vested and legal owner of real property located in the County of ____________________________, State of California, identified as
   1.1 Common address ____
   1.2 Legal description

2. ____ is:
   2.1 ☐ The Buyer of the property under a purchase agreement, option or land sales contract, or
   2.2 ☐ The Tenant under a lease of the property.
3. Within 10 days before the posting and recording of this notice, the undersigned Owner or Agent of Owner obtained knowledge that a work of improvement has commenced on the site of the property involving ☐ construction, ☐ alteration, or ☐ repair.
4. Owner will not be responsible for any claim arising out of this work of improvement.
5. I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: ____________, 20_____ Signature: ________________________________

☐ Owner, or ☐ Agent of Owner.

STATE OF CALIFORNIA

COUNTY OF ______________________________

On ______________________________ before me,

____

(Name and title of officer)

personally appeared ______________________________

______________________________.

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ______________________________

(Signature of notary public)

(This area for official notarial seal)

FORM 597 03-11

Scan this QR-Code for a PDF of the Form!

Mechanic's liens must be recorded within one of two periods of time:

- when a notice of completion or cessation of labor is recorded, the mechanic's lien of a general contractor must be **recorded** within 60 days (30 days for a subcontractor) of the date the notice of completion or cessation is recorded [CC §§8412(a); 8414(b)]; or
- if a notice of completion or cessation of labor is **not recorded**, all mechanic's liens must be recorded within 90 days of the date the project is completed or considered completed. [CC §8412(b)]

Foreclosing the mechanic's lien

A general contractor or subcontractor who has entered into a construction contract with the owner or tenant of a job site has timely served a 20-day preliminary notice on the owner and the construction lender. The general contractor or subcontractor may record a mechanic's lien against the property if he has not been paid as agreed.

If the mechanic's lien is timely recorded, it is enforced by filing an action to *judicially foreclose* the lien on the property. The action must be filed within 90 days after the mechanic's lien is recorded. [CC §8460(a)]

On failure to file the **foreclosure action** within the 90-day period, the mechanic's lien becomes *void*, no longer binding or encumbering the property. [CC §8460(a)]

Editor's note — An exception to this 90-day rule exists if the general contractor or subcontractor who recorded the mechanic's lien agrees to extend credit for payment of the mechanic's lien. The general contractor or subcontractor must record the fact and terms of this extension within 90 days of the recording date of the mechanic's lien.

To enforce the mechanic's lien after such an extension, the general contractor or subcontractor must file a foreclosure action within the lesser of:

- *90 days after the expiration of the credit to enforce the mechanic's lien; or*
- *one year after the completion of the labor in dispute. [CC §8460(b)]*

Notice of Nonresponsibility

Consider a tenant who is authorized by the landlord to make improvements on the leased premises.

If the tenant contracts for improvements and fails to pay, a mechanic's lien recorded by the unpaid general contractor will attach to the tenant's leasehold interest in the property. [CC §8442(a)]

Further, if the landlord or his property manager has *actual knowledge* of the construction, the mechanic's lien will also attach to the landlord's fee interest in the property unless the landlord records and posts a *Notice of Nonresponsibility* within 10 days after he becomes aware of the improvements. [CC §8442(b)]

A landlord who has actual knowledge a tenant is making improvements must record and post a **Notice of Nonresponsibility** to avoid the attachment of the mechanic's lien to the fee interest held by the landlord. [See Form 597 accompanying this chapter]

The Notice of Nonresponsibility is a written notice which must be **posted** in a conspicuous place on the property and **recorded** with the recorder's office in the county where the property is located within 10 days after the landlord becomes aware of the improvements. [CC §8444]

Economics

Chapter 90 Employment prerequisite to renting or owning

This chapter introduces the crucial need individuals have for employment to provide the income flow needed to rent or own housing.

Chapter 90 Outline

Income for the necessities of life
Quantity of employed individuals
Reeling from California's lack of jobs

Chapter 90 Terms

Employment *Under-employment*
Rentals

Income for the necessities of life

The **quantity of jobs** in California directly impacts homeownership statewide. Without a paycheck, nobody can afford to rent an apartment, or buy a house, unless they are subsidized by the government or possess substantial independent wealth.

The basis for an individual's **creditworthiness**, essential if they are to rent or borrow money for housing, is a paycheck, self-employed earnings from a trade or business, or income from investments.

When a jobholder decides to buy a home today, his decision to buy a particular property is influenced by the amount of his savings for a down payment, a lender's willingness to lend to the homebuyer and any available government promises of subsidies for the purchase.

Thus, of all the factors affecting the real estate economy, **employment** throughout California's population has the most impact on the vigor of the real estate market, whether in good economic times, times of financial crisis or economic recession.

Without jobs, wage earners have **no financial ability** to make rent or mortgage payments.

Thus, the unemployed are financially unable to occupy any type of residential property. Also, without work to provide jobs, businessmen have no need to occupy and use retail space, office suites, warehouses for inventory and distribution, industrial buildings for production or land for development.

Demand for all types of real estate rises as the number of local jobs increases (as during periods of economic development or boom). Additions to the local labor force tend to drive rents and prices up on properties in the vicinity.

On the other hand, a decline in the number of local jobs reduces the need for all types of real estate (as during a recession). Reductions in local employment lead to lower rents and prices paid by tenants and buyers for the occupancy and use of real estate.

The current trend of individuals employed in a region sets the direction for:

- the **volume of rentals** and sales in the local real estate market during the following 12 to 18 months; and

- the **movement of rents** and prices paid for the use and occupancy of all types of real estate in 24 to 30 months.

Figure 1

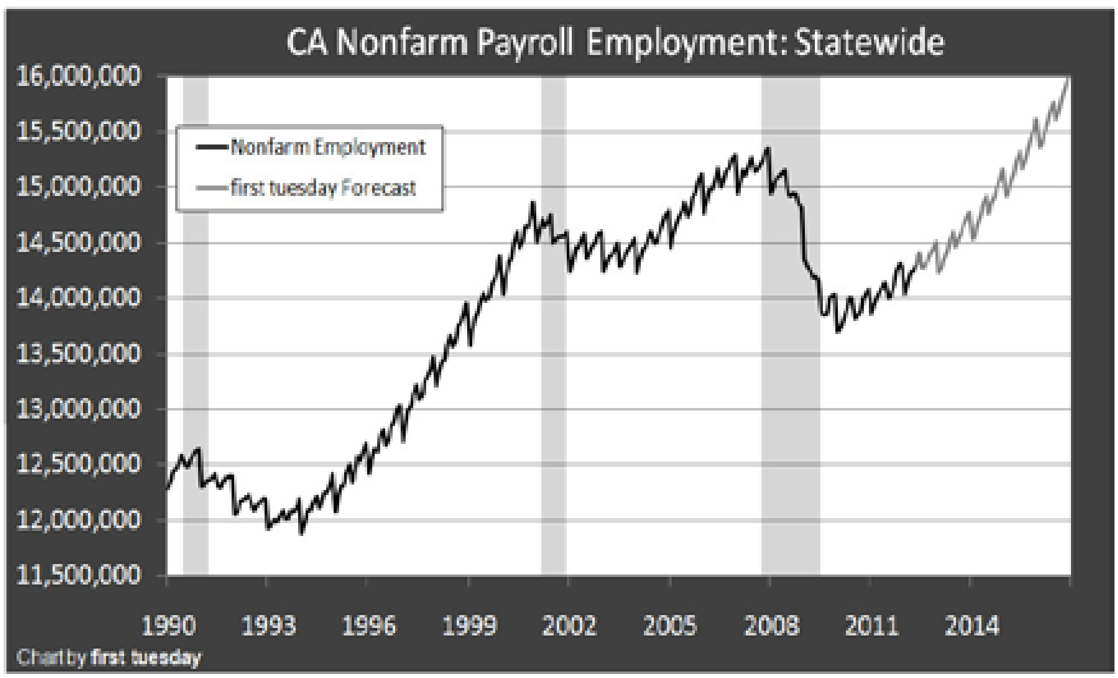


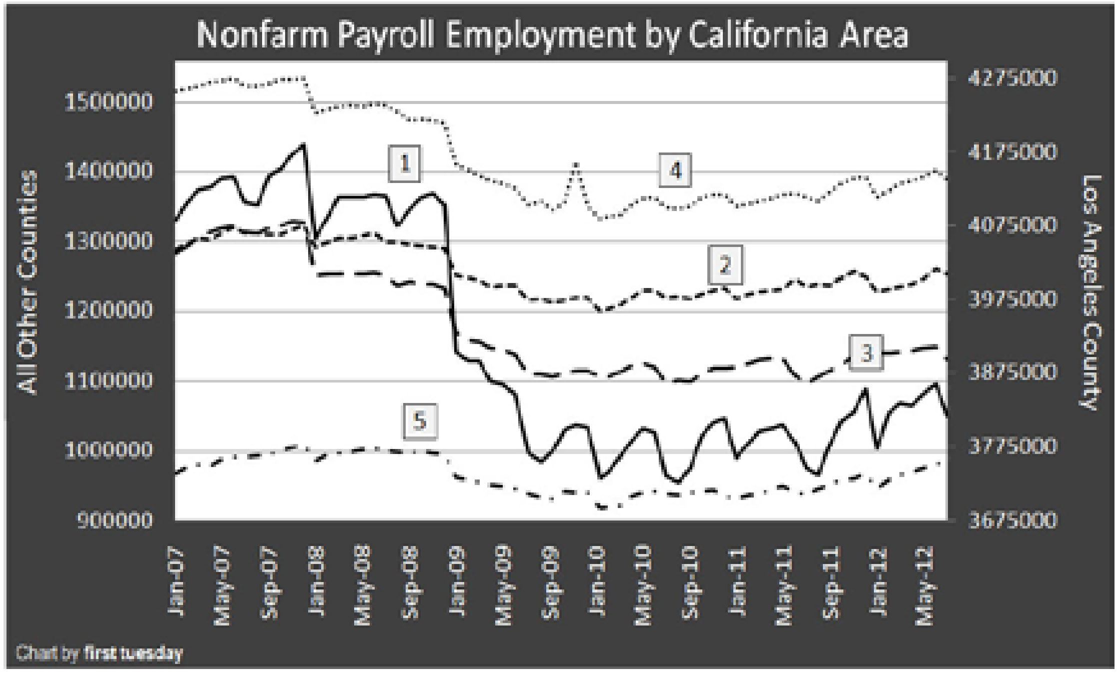
Figure 1 and Figure 2 track the single most important factor in determining the past and future of real estate in California: the number of people employed. These charts review total employment numbers statewide (Figure 1) and individually (Figure 2) for California's five most populous counties at the time of publication. The gray bars indicate periods of recession in the United States Economy (as tracked by the National Bureau of Economic Research).

Data Courtesy of the California Employment Development Department (Labor Market Information Division).

**Frequent updates of this and other charts are available at:*
http://firsttuesdayjournal.com/jobs-move-real-estate/

Smartphone users may scan this QR-Code for chart updates.

Figure 2



1. (Left Axis)	*Orange*
2. (Left Axis)	*San Diego*
3. (Left Axis)	*Riverside*
4. (Right Axis)	*Los Angeles*
5. (Left Axis)	*San Francisco*

Data Courtesy of the California Employment Development Department (Labor Market Information Division)

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Other jobs issues which affect the level of rents and prices paid for property include:

- **quantity** of employed individuals;
- **quality** of jobs available; and
- **type** of jobs existing and developing in the local market.

Quantity of employed individuals

Historically, jobs in California create homeowners and tenants on an approximate 50:50 basis, with half of all households owning the residence they occupy and the other half renting it.

The appreciation or depreciation of property values is triggered by increases or decreases in local population density and the economics of the jobs (read: numbers and pay levels) held by the local population.

The **unemployed**, the **under-employed**, and the rate of unemployment are of no concern to the present real estate market, since these populations do not rent or buy real estate — they first need a full time job to do so.

Figure 1 and Figure 2 track the single most important factor in determining the past and future of real estate in California: the number of people employed.

These charts review total employment numbers statewide and individually for California's five most populous counties at the time of publication.

The gray bars in Figure 1 indicate periods of recession in the United States Economy (as tracked by the National Bureau of Economic Research). [See Figures 1 and 2]

Reeling from California's lack of jobs

The overall rate of California unemployment dropped to 10.9% in July 2012. Meanwhile, the labor force participation rate rose slightly, to 63.1%.

These are positive signs, but the continuing low rate of labor force participation indicates that much of the population remains highly pessimistic about their ability to find work in the present market and is no longer actively looking for a job. Until jobs increase significantly, home sales volume has no chance of recovery.

Chapter 91 The timing and strength of the economic recovery

This chapter comments on whether California's recovery following the Millennium Boom, the Great Recession and the financial crisis can be predicted by studying post-World War II recessionary and recovery cycles.

Chapter 91 Outline

Divining the future from the past
Regional exceptions
The future for California

Chapter 91 Terms

Great Recession *Millennium Boom*

Divining the future from the past

Few would dare question the severity of the *Great Recession*, which officially started December 2007 and ended August 2009. Trillions of dollars in personal wealth evaporated nationally in home values. Along with this loss, California lost all the jobs created during the 2000's — 1.5 million.

Though its severity is unanimously acknowledged in California, less consensus has been achieved regarding the details of our eventual recovery.

But is it possible to extrapolate the details likely to surround future real estate market events — and the income of brokers and their agents — by analyzing historical recession and recovery trends from the past 50 years?

Historically, all 12 Federal Bank districts which comprise the U.S. (California is located in the 12th district under the San Francisco Federal Reserve Bank) have tended to exit a recession with greater uniformity of timing than when they entered it.

The dates of each district's entry into the **Great Recession** are widely divergent, spanning from the second quarter of 2007 (Atlanta) to the first quarter of 2009 (Dallas).

Some districts routinely experience longer and deeper recessions while other districts consistently rebound faster and stronger when compared to the national average.

During deep recessions, similar to the one California is now experiencing, each district tends to recover along a similar timeline since deep recessions are remedied with federal policy, filtering to each district at roughly the same time and triggering concurrent recovery.

Thus, it can be anticipated that California will pull out of the real estate recession at about the same time Nevada, Arizona, Georgia and Florida pull out.

Regional exceptions

This recession has some unorthodox characteristics which belie the universal national recovery hypothesis. In the San Francisco district, which covers all of the west coast, a primary cause of the contraction came from the 2002-2005 hyper-explosion of the real estate market and the following bust.

Traditionally, districts whose recessions are triggered primarily by real estate fluctuations take longer to rebound when compared to national recovery rates, as occurred in 1974, 1981 and 1991 in California, as concluded in a recent study entitled *Recession and Recovery Across the Nation: Lessons from History* written by Chad R. Wilkerson with the Federal Reserve Bank of Kansas (FRBK).

As California was home to the most inflated real estate prices in the country during the *Millennium Boom*, it will accordingly experience a more painful, slower recovery in direct proportion to its unusual excess. The contrary has occurred in Texas where the real estate market has already largely returned to normal, from Fort Worth/Dallas to the Mexican border, thanks in large part to their commodity based economy.

This national recession shares multiple commonalities with other post-World War II recessions. As before, Chicago and Cleveland entered the recession earlier than the rest of the nation and experienced greater job loss. Similarly, the Kansas City and Dallas districts expanded for a longer period than the rest of the nation before joining in the recession as their markets had not become so rapidly unemployed or overheated.

The future for California

Some notable exceptions exist when considering the recession as felt in the California district. During this recession, the California district entered slightly earlier than the rest of the nation. Historically, it enters late. The California district is also suffering one of the highest levels of job loss in the nation, which is uncharacteristic of previous recessions in which unemployment was proportionally lower.

In California, the brunt of job losses this time are felt in the construction industry which ballooned during the mid-2000s, then totally collapsed due to massive overbuilding, leaving little need for new single family residence (SFR) starts well into 2016.

Thus, the **Great Recession** in California is far deeper than any California recession felt since the Great Depression of the 1930s. Due to the unprecedented severity and depth of the current California recession, it is difficult to accurately predict the future by examining the past, as can be attempted with the national recession.

Thus, California is in uncharted territory. We possibly need to look no further than the 1930s for some guidance, since like the 1930s we have a financial crisis coupled with this recession and we have temporarily come to a stop, but this time with engines (read: people) warm and ready to go.

Real estate mathematics

Chapter 92 — Real estate mathematics

This chapter illustrates some of the fundamental real estate math concepts a real estate agent will be exposed to during their first four years of practice, including calculating area, fee percentages, loan and interest payments and general computations for real estate investments

Chapter 92 Outline

Chapter 92 Terms

Amortization schedule
Denominator
Financial calculator
Interest
Net operating income
Numerator
Principal balance
Straight note
Subcontractor

The mathematical tools you need

Anyone interested in real estate needs, as a requisite for entry into the profession, a thorough understanding of the formulas that are commonly used in the real estate industry and form the mathematical foundation of real estate transactions.

Once the basic formulas and an awareness of the logic behind them are mastered, most math issues in mortgages, income property, property management and investment capitalization are solved simply with a calculator.

A *financial calculator* is a wise investment in the real estate industry since most of the frequently used formulas are programmed into the calculator, such as **amortization schedules**.

A *nonprogrammable calculator* is provided during the agent and broker Department of Real Estate (DRE) licensing examination, which the examinee is well advised to use to ensure their accuracy.

Basic units of measurements in real estate

Before delving into problems involving land descriptions and areas, here is a review of basic units of land measurement:

Township = 36 square miles and is broken up into 36 sections;

Section = 640 acres and 1 square mile;

Half section = 320 acres, a quarter section = 160 acres, and a quarter of a quarter = 40 acres;

Acre = 43,560 sq. ft;

Mile = 5,280 ft;

Square mile = 27,878,400 sq. ft (5,280 ft x 5,280 ft) or 640 acres (27,878,400 sq. ft / 43,560 sq ft);

Square acre = approximately 209 ft x 209 ft ;

1 yard = 3 ft;

1 square yard = 9 sq. ft (3 ft x 3 ft);

1 mile = 320 rods; 5,280 ft; and

1 rod = 16.5 ft or 5.5 yards (16.5 ft x 3 ft).

Math basics

A grasp of mathematical basics is helpful when dealing with percentages, fractions and decimal points, all concepts common to real estate transactions.

Percentages

A percentage must be converted to a decimal before any mathematical computations can be completed, a conversion most financial calculators are preprogrammed to make.

When converting percentages to decimals, the basic rule to follow is to move the decimal point two spaces to the left.

Examples:

50% = 0.5

3% = 0.03

115% = 1.15

Alternatively, to convert a decimal to a percentage, move the decimal point two spaces to the right.

Examples:

1.43 = 143%

0.03 = 3%

0.5 = 50%

Fractions converted

Since the use of a calculator is allowed while taking the DRE state licensing exam, and recommended in practice, it is beneficial to convert all fractions to decimals and then use the calculator to complete the computations, much like converting percentages to decimals.

To understand fractions, it is helpful to understand their basic mechanics. A fraction is composed of a *numerator* and a *denominator*. The number on the top of the fraction is the **numerator** and the number on the bottom is the **denominator**.

When converting a fraction into a decimal, divide the numerator (the number on top) by the denominator (the number on the bottom).

Example:

4/5 = 0.8

1/2 = 0.5

3/4 = 0.75

3/100 = 0.03

667/100 = 6.67% = 6.67

Basic formulas for area

The formula for an area of a rectangle is most often used in land measurement.

Area of rectangle = length x width

A = L x W

Problem 1

A rectangular lot is 1,230 ft by 2,340 ft. What is the area of the lot in acres? (Round acres to the nearest whole acre.)

1. Area = 2,878,200 sq. ft (1,230' x 2,340').

2. Conversion of square feet to acres. (One acre equals 43,560 sq. ft.) 2,878,200 / 43,560 = **66 acres**.

Solution: 66 acres.

Problem 2

A rectangular lot is comprised of 10 acres. If the length of the lot is 500 feet, what is its width?

1. 10 acres = 435,600 sq. ft (10 x 43,560 sq. ft).

2. 435,600 sq. ft / 500 ft = **871.2 ft.**

Solution: 871.2 ft.

Problem 3

A rectangular lot is comprised of a quarter of a quarter (1/16) of a section of a township. The width of the lot is 800 feet, what is the length of the lot in yards?

1. A quarter of a quarter of a section is equal to 40 acres. (One section of a township equals 640 acres and 1/16 of a section (1/4 x 1/4) is 40 acres).

2. 40 acres = 1,742,400 sq. ft (40 x 43,560 sq. ft).

3. 1,742,400 sq. ft / 800 ft = 2,178 ft.

4. 2,178 ft / 3 = **726 yards**.

Solution: 726 yards.

Problem 4

A rectangular lot measures 1,652 ft by 2,430 ft. The cost per acre for the lot is $120. How much would the lot cost to purchase? (Round to whole acre.)

1. The lot area = 4,014,360 sq. ft (1,652 ft x 2,430 ft).

2. 4,014,360 sq. ft = 92 acres (4,014,360 / 43,560).

3. 92 acres x $120 = **$11,040**.

Solution: $11,040.

Area of a triangle

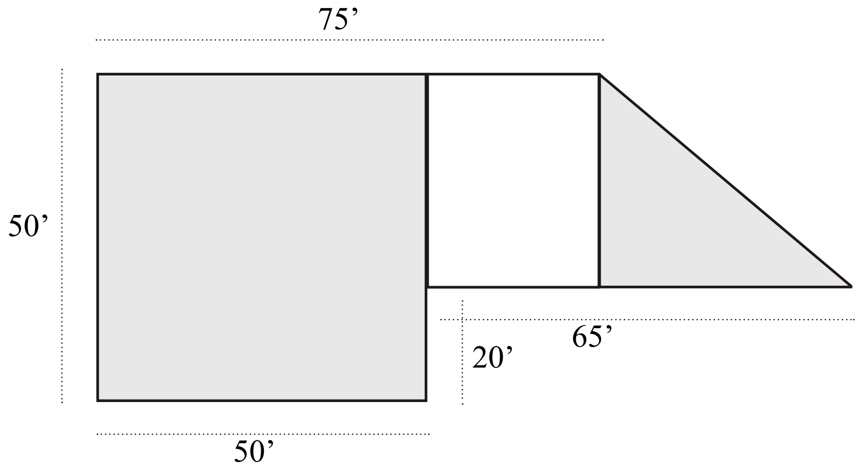
Another formula to be known by agents and brokers is the area of a triangle. This formula will be used when determining the area of a *triangular* shaped lot.

The area of a triangle equals its base multiplied by its height divided by two.

A = (B x H) / 2

Area of an irregular lot

An irregular lot is neither an even square or rectangle, or a triangle. Instead, it is mathematically broken up into smaller known shapes and its area then determined by a combination of the above formulas and the adding of the results.



First, divide the irregular shaped lot into even squares, rectangles and triangles. Compute the area of each shape individually then add them to equal the total area of the lot.

The square portion is 50 ft x 50 ft.

The lot area of the square = (50 ft x 50 ft); thus, **2,500 sq ft.**

The rectangular portion is 30 ft x 25 ft.

Editor’s note – Length = 50 ft (the length of the square) less 20 ft. Thus, 30 ft.

Width = 75 ft (the width of the square and rectangle combined) less 50 ft (the length of the square). Thus, 25 ft.

The lot area of the rectangle = (30 ft x 25 ft); thus, **750 sq ft**.

The triangular portion is (40 ft x 30 ft) / 2.

Editor’s note – Width = 65 ft (the width of the rectangle plus the bottom outer edge of the triangle) less 25 (the width of the rectangle). Thus, 40 ft.

The lot area of the triangle = 1,200 ft / 2; thus, **600 sq ft**.

Lastly, combine the lot area of each shape.

2,500 ft (the square) + 750 ft (the rectangle) + 600 ft (the triangle) = **3,850 sq ft**.

Solution: 3,850 sq ft.

Problem 1

A triangular lot features a 200 ft base and a height of 150 feet. How many square feet are contained in the triangular lot?

1. The lot area = (200 ft x 150 ft) / 2.
2. 30,000 ft / 2 = **15,000 sq. ft**.

Solution: 15,000 sq. ft.

Percentage formula

The percentage formula is a basic formula used in real estate mathematics and is of primary importance as it is typically used to determine the amount of a *broker's fee* on a transaction.

The **broker's fee** is typically a percentage of the sales price, loan amount or total rents that the broker is entitled to as compensation for their service.

The percentage formula is easily converted to suit a variety of situations.

Usually, two of the three variables will be known, leaving the third to be determined. Understanding the basic formula makes solving problems a question of mechanics.

The percentage formula is as follows:

Fee = Percent (%) x Principal

Percent (%) = the rate charged;

Principal (P) = the dollar amount of the price, loan or rents; and

Given the basic formula and two of the three variables, solutions are determined as follows:

To determine the fee, multiply the principal by the rate.	**P x %**
To determine the rate, divide the fee by the principal.	**Fee / P**
To determine the principal, divide the fee by the rate.	**Fee / %**

Problem 1

A broker will earn a 3% fee on the sale of a home listed at a selling price of $100,000. If the home sells for the listing price, how much will the broker earn?

Consider what we know:

% = 3%

P = $100,000

Using the percentage formula: Fee = % x P

1. Fee = 3% x $100,000
2. Fee = 0.03 x $100,000
3. Fee = $3,000

Thus, the broker earns a fee of **$3,000**.

Solution: $3,000

Problem 2

An agent employed by the broker shares in the broker's fee based on 40% of the 3% fee the broker will be paid on a transaction.

The home sells for $245,000 (alternatively, this is the total loan amount in a mortgage loan brokerage situation, or the total amount of all rents due under a lease in a leasing situation).

How much will the agent earn?

Start with what we know to determine the broker's fee:

% = 3%

P = $245,000

Using the percentage formula:

1. Fee = 3% x $245,000
2. Fee = 0.03 x $245,000
3. Fee = **$7,350**

Thus, the broker will earn $7,350. The sales person will then receive 40% of $7,350.

Using the percentage formula:

1. Fee = 40% x $7,350
2. Fee = 0.4 x $7,350
3. Fee = $2,940

The agent receives **$2,940** on the close of the transaction.

Solution: $2,940

Problem 3

A real estate transaction involves both a seller's broker and a buyer's broker. The brokers agree to split a 6% fee paid by the seller 50-50.

You are the buyer's broker's agent and will receive 70% of the fee your broker receives.

If the home sells for $149,500, how much will you receive?

First, compute the total fee to be received by both brokers.

1. Total fee = 6% x $149,500
2. Total fee = 0.06 x $149,500
3. Total fee = $8,970

Thus, the total brokerage fee is **$8,970**.

Second, calculate the seller's broker's fee:

1. Seller's broker's fee = 50% x $8,970
2. Seller's broker's fee = 0.5 x $8,970
3. Seller's broker's fee = $4,485

$4,485 is the amount the seller's broker will receive on the close of the transaction.

Finally, calculate your share of the fee on in the deal:

1. Your fee = 70% x $4,485
2. Your fee = 0.7 x $4,485
3. Your fee = $3,139.50

You will receive **$3,139.50** from your broker on the completion of the sale.

Solution: $3,139.50

Problem 4

A broker lists an office building for sale. The listing agreement calls for a graduated fee payment computation. The broker agrees to accept a fee of 5% on the first $150,000 and a smaller percent on the remaining sales price.

The broker sells the office building for $240,000 and earns a total fee of $11,150.

What is the percent of the sales price the broker has agreed he is to be paid on amounts over $150,000?

The broker earns 5% on the first $150,000 and an unknown percentage on the remaining $90,000 ($240,000 sales price - $150,000). The total fee received is $11,150.

Using the percentage formula (Fee = % x P), determine the fee on the first $150,000.

1. \$11,150 = (5% x \$150,000) + (?% x \$90,000)
2. \$11,150 = (0.05 x \$150,000) + (?% x \$90,000)
3. \$11,150 = \$7,500 + (?% x \$90,000)

Next, determine the percentage the fee amount is of the remainder of the price.

4. \$11,150 - \$7,500 = ?% x \$90,0000
5. \$3,650 = ?% x \$90,000
6. \$3,650 / \$90,000 = 0.040

Convert the amount to a percent by moving the decimal two spaces to the right. Therefore, the fee is **4%** on the amount over \$150,000.

Solution: 4%

Loan problems

The percentage formula can also be used in loan calculation problems.

Cost of using the lender's money = *Cost*

Interest rate = *Percent*

Principal amount of the loan = *Principal*

When calculating problems involving simple interest, the interest rate is the rate of interest over one year.

Interest can be further broken down into months by dividing the annual interest rate by 12, and into days by dividing the interest rate by 360 (months are uniformly considered to be 30 days to avoid awkward numbers).

Financial calculators and *amortization tables* make interest calculations easier. An **amortization table** is a schedule of monthly loan payments which show the amount of principal and the amount of interest which comprise each constant payment until it is paid in full.

Early in the amortization schedule, a majority of the monthly payment is applied to *interest*. However, towards the end of the schedule, most of the monthly payment is applied towards the diminishing *principal balance*.

In loan problems, **time** is an important factor and is part of the percentage formula. Thus, the percentage formula is modified slightly for loan problems as follows:

Cost of borrowing money (C) = Interest Rate (%) x Time (T) x Principal (P)

C = % x T x P

When dealing with interest rates for different periods, remember the following:

- for annual interest, the interest rate is the percent given;
- for monthly interest, the interest rate is equal to the interest rate given divided by 12 (for the 12 months in the year); and
- for daily interest, the interest rate is equal to the interest rate given divided by 365 (for the 365 days of the year).

Problem 1

A borrower owes $15,000 on a *straight note* payable at the end of the quarter. The borrower will pay $250 in total interest costs with the timely payoff of the principal. What is the interest rate on the loan?

Editor's note – A quarter is equal to 3 months.

Using the modified percentage formula and the information given above:

1. $250 = ?%/12 months x 3 months x $15,000
2. $250 = ?%/4 (one quarter) x $15,000
3. $250 x 4/$15,000 = ?%
4. .067 = ?%

Thus, the interest rate on the loan in terms of a percent is **6.7%**.

Solution: 6.7%

Problem 2

If an investor earns $360 on a straight note with an interest rate of 8% payable in 60 days, what is the principal amount of the loan?

C = % x T x P

1. $360 = 8%/360 days x 60 days x P
2. $360 = .08/360 days x 60 days x P
3. $360 x 360 / 0.08 x 60 = P
4. $27,000 = P

The principal amount of the loan is **$27,000**.

Solution: $27,000

Investment and cost problems

Calculations may be required in real estate transactions to determine the expected profit from a sale or the amount an investor should pay to receive a required rate of return.

Problem 1

A seller wants an 8% return (profit) on a $125,000 investment he has in an unencumbered property he owns.

What is the minimum net selling price the seller needs to receive to realize the 8% rate of return?

First, consider that at $125,000, the seller has a 100% return of his investment. Thus, the seller needs to realize a 108% total return to receive an 8% return on his investment.

Using the percentage formula and the information given:

1. Net price = 108% x $125,000
2. Net price = 1.08 x $125,000
3. Net price = $135,000

For an 8% profit on the original investment, the seller must net **$135,000** on the sale.

Solution: $135,000

Problem 2

A lender purchases a **straight note** at an 18% discount. The note has a remaining principal balance of $60,000 and a 10% interest rate.

What is the lender's annual yield on his investment in the straight note?

First, compute the amount the lender paid to purchase the principal remaining due on the note:

1. $60,000 x 18% = the amount of the discount.
2. $60,000 x 0.18 = **$10,800**

The principal amount of the note minus the amount of the discount equals the investment the lender has in the note:

3. $60,000 - $10,800 = **$49,200**

Next, determine the dollar amount of the annual interest accruing on the $60,000 principal remaining due on the note.

4. Annual interest = 10% x $60,000
5. Annual interest = 0.10 x $60,000

6. Annual interest = $6,000

Lastly, divide the dollar amount of the annual interest ($6,000) accruing on the note's principal by the amount invested in the note, i.e., the purchase price ($49,200):

7. $6,000 / $49,200 = 0.1219

7. 0.1219 = ?%

Thus, the lender realized a **12.19%** rate of return on the investment in the straight note.

Solution: 12.19%

Problem 3

A subdivider purchases three lots for $150,000. He subdivides the three lots into nine parcels. The parcels are all sold for $25,000 each.

What is the subdivider's rate of return on his investment?

First, calculate the total amount received for the nine parcels:

1. (9 x $25,000) = $225,000

Next, subtract the owner's cost:

2. $225,000 - $150,000 = $75,000

Thus, $75,000 is the amount the owner realized in profit – his return on his investment.

Next, use the percentage formula to determine the rate of return on the investment:

3. $75,000 = ?% x $150,000
4. $75,000/$150,000 = ?%
5. 0.50 = ?%

Thus, the rate of return on the investment is **50%**.

Solution: 50%

Problem 4

An owner sells property for $250,000. The owner takes a profit of 15% over the amount he has invested in the property.

How much has he invested in the property?

The way to conceptualize the problem is as follows: the owner will receive a 100% r**eturn of** his investment in the property, plus an additional **return on** his investment of 15%. Thus, his total return will equal 115%.

Use the percentage formula to determine how much the owner originally paid for the property:

1. \$250,000 = 115% x P
2. \$250,000 = 1.15 x P
3. \$250,000/1.15 = P
4. \$217,391.30 = P

Thus, the investor originally paid **\$217,391.30** for the property.

Solution: \$217,391.30

Problem 5

An investor purchased property listed at \$100,000. The investor paid 15% less than the property's listed price. The investor then resold the property at the prior owner's listed price.

What is the investor's rate of return?

First, determine the price the investor paid for the property. If the investor received a 15% discount on the listed price, the investor paid 85% (100% - 15%) of \$100,000, the listed price.

1. Price paid = 85% x \$100,000
2. Price paid = 0.85 x \$100,000
3. Price paid = \$85,000

Since the investor sold the property for \$100,000, the investor made a \$15,000 profit on the sale.

Using the percentage formula:

4. \$15,000 = ?% x \$85,000
5. \$15,000/\$85,000 = ?%
6. 0.1765 = ?%

The investor received a **17.65%** rate of return on the purchase and sale of the investment property.

Solution: 17.65%

Problem 6

A seller wishes to net a 14% profit over the original \$240,000 purchase price of real estate.

What sales price must the property receive to yield a 14% profit over the original price after the broker is paid a 6% fee out of the net proceeds? (Round answer to nearest whole number.)

Using the percentage formula, determine the amount of next proceeds the seller must receive to realize a gain of 14% over the original purchase price. The owner's net proceeds must be 114% of his original investment.

1. Net proceeds = 114% x $240,000
2. Net proceeds = 1.14 x $240,000
3. Net proceeds = $273,600

The net proceeds from the sale of the property to yield a 14% return on his investment would be **$273,600**.

To determine the sales price after the 6% broker's fee, consider that $273,600 equals 94% (100% - 6%) of the total sales proceeds needed to net 14% after the 6% fee.

Using the percentage formula:

4. $273,600 = 94% x P
5. $273,600/0.94 = P
6. $291,063.83 = P

Rounding to the nearest whole number, the price needed on a sale to yield 14% over the original purchase price after paying a 6% broker's fee is **$291,063**.

Solution: $291,063

Capitalization rate

With income producing property, the value of the property is determined by **capitalizing** the *net operating income (NOI)* generated by the property (rental income minus operating expenses).

The rate of return an investor expects on his investment after rental operating expenses are subtracted from rental income (producing the **NOI**), is called the *capitalization rate (cap rate)*.

Returning to the percentage formula:

Net operating income or loss = **NOI**

Capitalization rate = **%**

Purchase price = **P**

Problem 1

An apartment building produces an NOI of $24,000. A buyer seeks an annual rate of return of 12%.

What is the price the buyer should pay for the property?

Using the percentage formula:

1. $24,000 = 12% x P
2. $24,000/0.12 = P
3. $200,000 = P

Thus, the buyer should pay no more than **$200,000** to yield a 12% rate of return.

Solution: $200,000

Problem 2

Rent on each unit in a four-unit apartment building is $545 per month. The owner has been receiving a return equal to an 8% c**ap rate** on his investment in the property.

If the rent for each unit drops to $500 per month, what is the owner's loss in value over the year?

First, determine the rental loss for all units over the year.

1. $545 - $500 = $45 loss per unit per month
2. $45 x 12 = $540 loss per year per unit
3. $540 x 4 = $2,160 loss for the entire complex

Using the percentage formula:

4. $2,160 = 8% x P
5. $2,160/0.08 = P
6. $27,000 = P

Thus, the owner suffers a **$27,000** loss in value over the year.

Solution: $27,000

Editor's note – This can also be calculated by subtracting the total annual rent at $500 per month from the total annual rent at $545 per month. Problem 3 below illustrates this alternative method of calculation using a different set of facts.

Problem 3

An owner owns a 5-unit apartment building. The owner uses a cap rate of 10% on his investments. The owner usually realizes an NOI of $650 per month per unit. However, due to an increase in rents, the owner now nets $700 per month per unit.

What is the corresponding increase in value for the apartment building?

First, compute the value of the apartment building when the net income was $650 per unit.

The total net income over the year for the apartment building is **$39,000** ($650 x 5 units x 12 months).

Using the percentage formula:

1. $39,000 = 10% x P
2. $39,000/0.1 = P
3. $390,000 = P

Next, compute the value of the apartment building at the new net income.

The new total net income over the year for the apartment building is **$42,000** ($700 x 5 units x 12 months).

Using the percentage formula:

4. $42,000 = 10% x P
5. $42,000/0.1 = P
6. $420,000 = P

Thus, the increase in value for the apartment building is **$30,000** ($420,000 - $390,000).

Solution: $30,000